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Globalization of Financial Markets: Implications, Vulnerabilities, and Opportunities

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An Intelligence Assessment

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GI 86-10073
October 1986

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An Intelligence Assessment

This paper was prepared by the Office of Global Issues. Comments and queries are welcome and may be directed to the Chief, Economics Division, OGI,

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Globalization of Financial Markets: Implications, Vulnerabilities, and Opportunities

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Summary

Information available as of 1 October 1986 was used in this report.

The globalization of financial markets has been one of the most revolutionary structural changes in the world economy over the past decade. Since late in the last decade, we have seen an unprecedented restructuring of these markets: traditional distinctions have been blurred between domestic and international markets, between different types of financial transactions, and between who is a market participant and who is not. At the same time, there has been an explosive increase in the speed, size, and scope of international money transactions. As a result, international financial markets have become a connective medium that interlocks political and economic phenomena worldwide.

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We believe this globalization of financial markets has been the result of the confluence of three underlying trends. First, the oil shocks of the 1970s enabled the capital markets to recycle billions of petrodollars out of the Persian Gulf, through Western money centers, to Third World borrowers; more recently, the Japanese have exported a large share of their capital surplus to the United States. Second, the rapid advances in computer and telecommunication technologies have enabled financial traders to integrate and accelerate international transactions. Finally, a wave of financial deregulations has swept through the Western money centers, bringing with it greater competitive pressures that have led to widespread market innovations.

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Financial integration caused by the globalization process has not only been accelerating but has outstripped any corresponding political integration or evolution of economic policy coordination. The transformation of international financial markets is demonstrated by several statistics: foreign exchange transactions now exceed $100 billion per day; interbank deposits stood at $1.4 trillion last year, twice the 1981 level; and international bank financing rose 43 percent in 1984, and another 26 percent last year. The number of international banks is now in the hundreds, up from just a handful in the 1970s; offshore banks have multiplied each year for the last few years; and the volume of Euromarket transactions has probably tripled since the 1970s. Finally, new financial instruments are appearing on the markets faster than either the traders or the regulators can fully understand them.

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The increased capabilities of the financial system have facilitated greater growth and efficiency of the world economy. For the United States, these changes have made it easier to tap Japanese and European surplus capital for financing large US trade and fiscal deficits and have brought productive investment to US soil. The resulting growth of the US economy has, in turn, fueled increased economic activity worldwide. Despite such broad positive consequences, we believe the new financial environment is creating some potential risks.

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Directly, the globalization of financial markets has created a highly fluid medium through which political and economic shocks in one area are quickly and forcefully transmitted to the rest of the globe. As a result, markets are increasingly sensitive to news, and, therefore, have become more volatile. This volatility, in turn, can cause broader economic and political fluctuations, both internationally and within countries. Sudden shifts in exchange rates as a result of political events can stimulate further speculative attacks on a country's currency—quickly draining foreign exchange reserves if a government chooses to insulate itself from currency changes.

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Indications are that the international financial system may be becoming less stable. While some observers argue that the broadening of the investor base and enhanced information flows have bolstered the overall system, there are worrisome trends. First, sharp competition has lowered the risk threshold that some lenders are willing to accept. Second, the declining power of regulators is encouraging institutions to take greater risks and is eroding regulatory authorities' ability to foresee potential stability problems and react to them. Third, the vulnerability of the international electronic funds-clearing system is on the rise as the volume and speed of transactions increase. Finally, the spread of new financial instruments is outpacing the ability of both regulators and traders to understand the underlying risk or value of the transactions.

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Along with the globalization of international finance has come the greater use of the financial system by governments and groups whose objectives threaten Western security interests. Aside from the multibillion-dollar international narcotics money-laundering industry, terrorist activities, gray arms purchases, technology transfer, and nuclear proliferation are often funded through the world's financial networks. Participants in these

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activities find the speed, ease, and anonymity associated with the use of the system attractive for their purposes. In addition, the increased size and sensitivity of the markets have raised the opportunities for tampering, increasing the vulnerabilities of small countries.

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Less directly, the globalization of financial markets has tended to accelerate longer term trends in resource flows. The large foreign exchange needs caused by the LDC debt problem have forced many Third World countries to boost exports, which has raised protectionist sentiments in the developed countries. By facilitating the large flow of capital into the US economy, international financial markets have made possible massive imports of foreign goods into the United States. Along with the shift of some industries offshore, such shifts in trade balances have contributed to protectionist pressures.

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International financial markets are also contributing to a reconfiguration of international cooperation. At the policy level, the increased integration of the various domestic economies with world markets has made fiscal and monetary cooperation more important, yet more difficult. At the industrial level, cross investment between countries is blurring the corporate ownership picture—raising concerns about the production of strategic goods and broader control of the economy. As a result, we believe there may be a backlash against foreign investment in such areas as Western Europe and, perhaps, some restrictions on capital outflows, which may raise international tensions over an emerging "investment protectionism."

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How these emerging ramifications will affect any given region will depend largely on the magnitude of resource flows through the region and on the extent the region participates in the international financial system:

- *Japan* is likely to continue to be the source of massive capital outflows. This could lead to greater Japanese leverage over countries in which it invests. At the same time, the role of the yen in the world economy is likely to increase as the Japanese economy grows—again leading to a greater importance for Japanese economic policy.

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- *Western Europe* wants to ensure its place as a world financial center, and several West European countries are taking steps to deregulate their capital markets to achieve this goal—despite the problems this may raise for large international capital movements. Western Europe's exports and economic growth benefited during the first half of the 1980s from the strong dollar. If the more recently falling dollar begins to impair their trade position, West European countries will show some concern about US policy, and protectionist pressure may increase. West Europeans also claim that US budget deficits are keeping interest rates unnecessarily high and almost certainly would become worried about capital flows if US interest rates started moving back up to the levels of the early 1980s.

- *The Third World* has been most affected by the evolution of the international financial scene. The foreign debt situation has become the most important single influence on both the economic and political stability of many LDCs important to the United States. While there could be increased domestic unrest as a result of poor economic performance, relations with the United States are likely to be strained as Latin America focuses on the debt issue, the Africans on aid, and the Asians on protectionism.

- *The Middle East* is facing rapidly growing financial problems as the major oil exporters must draw down their external assets to fund current expenditures. Moreover, surrounding economies will continue to suffer as the Persian Gulf countries—normally the region's economic powerhouses—no longer provide stimulus. Although this will mean less Saudi aid, it could also mean severe financial problems for Iran, Iraq, Libya, Syria, and groups such as the Palestine Liberation Organization.

- In the *Soviet* sphere, Moscow is facing declining earnings from its premier export—oil. The USSR's hard currency surplus dropped from $4.4 billion in 1984 to $1 billion last year. These shortfalls will put greater pressure on domestic food programs, as well as Soviet acquisition of foreign technologies. Similarly, Moscow's belt-tightening, coupled with the benefits provided by participation in the international financial community, may lead to a greater Western orientation by Eastern Europe and the Soviet-supported LDCs.

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- *China's* future participation in the international financial markets could become one of the most important issues of the last half of this decade. Some observers believe China could quickly become a large capital importer—radically altering capital flow patterns worldwide. Moreover, China will have sovereignty over a major financial center when it assumes control of Hong Kong.

In each of these cases, US leverage is affected by shifts in the financial flows, and the importance of the US economy at the global level will mean continued pressure by foreign governments on Washington to keep external impacts in mind when formulating US policy.

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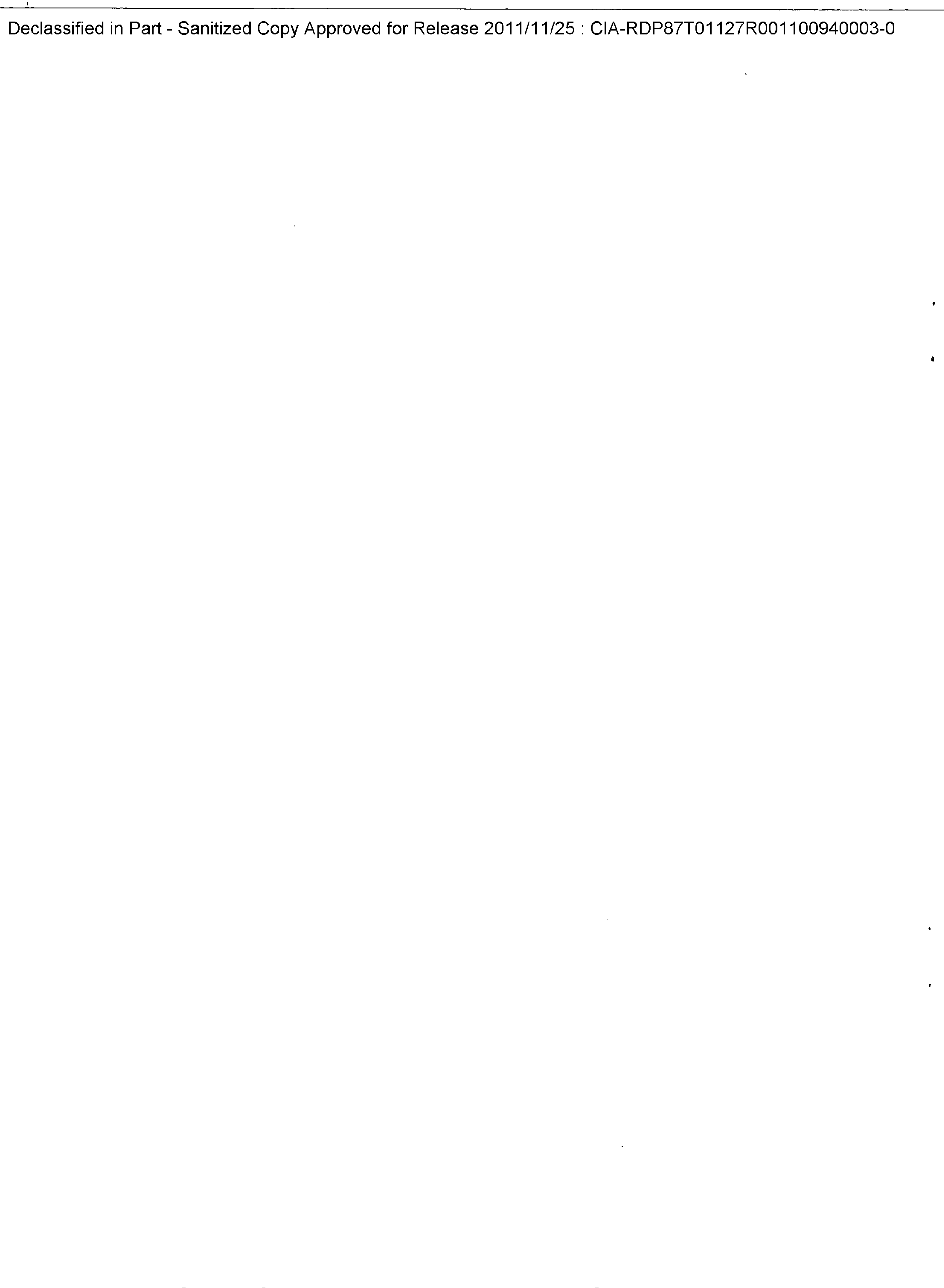

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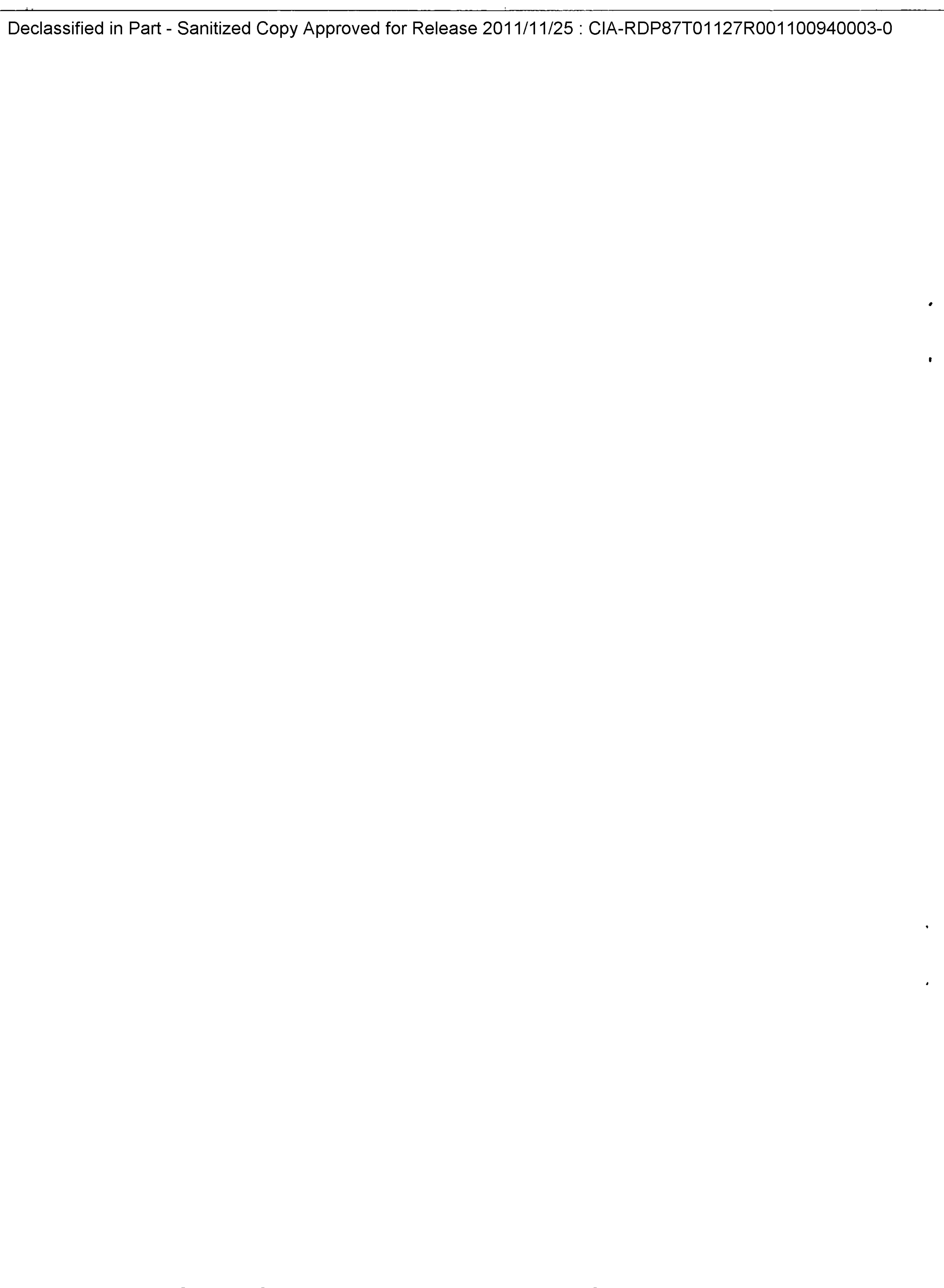

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Scope Note

This study is one of a series the Directorate of Intelligence is undertaking on the question of structural change in the global economy. It addresses shifts occurring in international financial markets, the way the international financial system is now used, and the implications for economic and political balances. While financial globalization has had an overwhelmingly positive impact, it has also created new risks and vulnerabilities that this speculative study tries to highlight. We also recognize that financial globalization is part of a larger process of internationalization that is occurring. With this in mind, we are currently preparing a report on the globalization of industry, including the movement of technology from country to country. Other issues we intend to examine include the impact of globalization on agriculture where markets are also undergoing dramatic structural change.

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Globalization of Financial Markets: Implications, Vulnerabilities, and Opportunities

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Introduction

Structural changes in the world economy set into motion by the technology revolution and its accompanying forces are having a profound impact on a wide range of national security issues. While much of the emphasis has been on such issues as industrial competition and shifts in global economic balances, a fundamental and less understood change is occurring in the international financial realm. Technology has created the global, nearly instantaneous communications network that has globalized national financial markets into a cohesive whole.

The consequences of this globalization reach far beyond the financial arena as both economic and political pressures are transmitted through the increasingly fluid international financial system. At one level, the emerging global market has simply raised the speed and magnitude of economic changes brought about by other forces—the internationalization of production, for example. At a more immediate level, the globalization of financial markets has created its own vulnerabilities and opportunities for governments, groups, and individuals worldwide. The delicate nature of the international financial network, for example, has created the potential for relatively small groups to use the international financial system to damage entire nations and to disrupt strategic balances in certain regions.

Factors such as the explosion in the types and varieties of financial instruments have also raised new vulnerabilities. A case in point is the growing volume of trading on the options markets where billions of dollars change hands on a daily—even hourly—basis. Beyond this, the level of risk taking that occurs in these markets is being driven by aggressive, young individuals with little stake in the system. In this environment, the risk of accidents because of simple miscalculations or lack of historical perspective is only intensified. Unlike the stock exchange, these new markets—sometimes called synthetic markets—are high-risk environments because there are no real assets backing the transactions.

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The Globalization Process

The global financial system is a complex matrix that interlocks individuals, businesses, and governments worldwide. Its components range from the major Western money-center banks with their satellite telecommunications networks to massive black-market foreign exchange operations that flourish throughout the Third World. This system is the connective medium that enables the constant flow of global resources and has consequently become the world's central information clearinghouse.

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During most of the post–World War II period, the international financial system was largely a facilitator of international trade, and its growth closely matched that of trade volumes. The dominant organizational influences in the international financial markets were a few large banking institutions in the developed West, which largely operated apart from the domestic financial markets. The 1970s saw an unprecedented globalization of these markets: differences were blurred between international and domestic markets, between the different kinds of financial transactions, and between who was a market participant and who was not.

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This globalization of financial markets, which continues to accelerate in the 1980s, has been brought about by a confluence of evolving forces. As the size of the capital markets increased, the technology revolution enabled funds to move more rapidly. At the same time, deregulation helped ensure that many of the obstacles to financial growth and acceleration were eliminated.

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Capital Flows: Swelling the Financial Markets

The oil price increases of the 1970s caused massive shifts in capital from the developed economies to the emerging Third World economies. New strains were put upon the financial system to channel these funds. At first, capital flowed from the oil importers of Japan, Europe, and the United States to the newly rich oil exporters—mostly in the Middle East. The large trade surpluses—in the form of petrodollars—were deposited in Western banks, which turned to Third World borrowers to soak up the growing volume of loanable funds. Prior to the onset of the Third World debt crisis in late 1982, the rising profits of international banking were attracting new, larger players into the market. As the 1980s unfolded, capital flows were again expanding sharply—this time from revenue-rich Japan to the growing US economy. Indeed, Japan's capital surpluses have overtaken OPEC's surplus peaks of the early 1980s.

Information Technology: Enabling a Revolution

The exponential globalization of the financial system has been rendered possible by the development and implementation of information technologies throughout the finance industry:

- *Computer technology* has allowed the number of transactions the international system can process to expand by several orders of magnitude over the past decade. For example, new computers installed in the Hong Kong Stock Exchange in April tripled the capacity of that market: it now takes only seven seconds to complete a multimillion-dollar sale there, according to local press reports. Moreover, computers have enhanced the quality of news and technical information available to investors and speculators—enabling them to shift funds more quickly as world events unfold.

- *Telecommunications technology* has allowed greater access to international financial markets by speeding the flow of price and other information. The global communications network makes possible a higher volume of instantaneous transactions among finance and commodity markets on every continent. The Sydney Stock Exchange, for example, is linked to Amsterdam, Montreal, and Vancouver exchanges to trade listed options in gold, silver, and selected foreign currencies, according to trade reports.

The convergence of computers with telecommunications has produced the infrastructure for the truly global marketplace. Within the next three years, for example, eight of the top 10 stock markets in the world will be operating some form of computerized trading system capable of integrating into a single global market. Traders report that talks are now under way to link the British, French, West German, and Japanese stock listings.

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While these technological advancements provide obvious efficiencies for the larger financial institutions, the smaller financial players formerly on the fringe of the market are also afforded greater access. Such players may ultimately prove to be the most critical phenomenon of globalization as even individuals in LDCs gain access to high-quality information and are able to execute large-scale financial transactions that, until recently, were reserved for the major financial centers in the developed West.

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Deregulation: Unleashing the Free Market

Although many observers cite government deregulation as a driving force behind globalization, we believe that government regulatory efforts were overwhelmed by free market innovations and the inevitable integration of the maturing world markets. Nevertheless, liberalization of financial regulations has removed many of the obstacles to globalization:

- *Japan* has moved to open its domestic financial market to foreign banks. Foreign institutions are now allowed to trade government securities and underwrite new Euroyen offerings, and last year Tokyo gave nine foreign banks licenses to operate in Japan. Japanese banking power is also moving abroad. The Ministry of Finance has given its approval for six major Japanese banks to move into the US pension-fund industry. This will solidify many links between the Japanese and US finance industries.

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- Following the US lead in July 1984, *West Germany* and *France* abolished withholding taxes on domestic bonds owned by foreigners, encouraging foreign financial players to move in and out of those markets. Moreover, France recently reopened its Eurofranc market, and Germany eased restrictions on issuances of deutsche mark–denominated bonds by foreigners, while allowing creation of several new financial instruments.

- The *United Kingdom* is in the process of implementing the "big bang"—a broad liberalization of its financial markets in an effort to remold London's long overprotected institutions into full-service conglomerates capable of competing worldwide. London banks, as well as banks from the United States and Europe, have taken over almost all of the London Exchanges' two dozen largest firms. This year London will begin to allow foreign competition in its government bond market—the second largest in the world.

Reshaping the Global Economy

The sheer magnitude of financial globalization has had far-reaching effects. In the day-to-day operations of the markets, the financial revolution can be seen in the tremendous growth of the speed, size, and scope of financial transactions. This revolution has, in turn, facilitated the massive capital movements across the globe that have changed the current landscape of the entire global economy.

The Financial Markets

The international financial system, together with the domestic financial sectors, is rapidly becoming a unified international marketplace. This new global industry has radically altered the traditional dimensions of international money trading:

- *Continuous and immediate*. The larger banks now operate their own international telecommunications networks. These links, coupled with expanded trading in every region of the Western world, have resulted in a 24-hour market. Besides making large transactions possible at any time, it is now possible to transfer control over hundreds of millions of dollars in a matter of minutes. The first indications of breaking world events are often seen in the immediate movements of interest rates, exchange rates, and capital flows.

- *Large and growing*. The volume of capital flows across national borders now greatly exceeds the value of international trade. Foreign exchange transactions alone, for example, exceeded $100 billion per day last year. By comparison, one week of funds transfers on the international market is roughly the size of the Third World debt. It is not uncommon for millions of dollars to flow out of a country's money center on rumors of a major event, just to flow back in again when the rumors subside minutes later. Moreover, capital transfers from country to country for industrial expansion and import financing are now greater than the peak of petrodollar flows in the 1970s. According to OECD statistics, total international bank financing rose 43 percent in 1984, and another 26 percent last year. The amount held in interbank deposits stood at $1.4 trillion last year—more than double the 1981 level.

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The market structure of the world's finance industry is also being reshaped as globalization takes hold:

- The number of *international banks* is now in the hundreds—up from just a handful in the early 1970s. These banks operate an interlocking network of more than 4,000 regional offices worldwide. In Miami alone, there are now 40 foreign-owned bank branches, with deposits of nearly $4 billion—up 45 percent last year. More important, these numbers significantly understate the profusion of market players: deregulation has allowed the entry of previously locked-out institutions, including such untraditional financiers as General Motors.

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- The explosive rise of *offshore money centers*. The flight of trading activity to less regulated markets in Third World countries has been tremendous. For example, the number of banks in Anguilla grew from two in 1983 to 200 last year. Panamanian banks now hold $35 billion in foreign deposits—an amount eight times the size of Panama's annual

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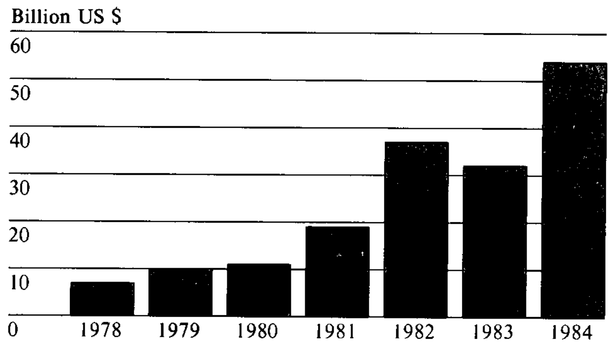
gross national product—and have virtually no reporting requirements. In addition, such places as Bahrain, the Channel Islands, the Caicos Islands, the Turks Islands, and The Bahamas have become significant second-tier banking centers trying to match the growth of the better known centers of Singapore, Hong Kong, Luxembourg, and Liechtenstein.

- The *Euromarkets* have moved to the fore of international trading by more than tripling in size since the mid-1970s, according to Bank for International Settlements (BIS) statistics (figure 1). These markets—in which money instruments, bonds, and securities are denominated in the currencies of foreign countries—are abstractions that have no physical locations and are therefore an important element of globalization because their supranational nature makes effective control by government regulators very difficult. As a result, the Euromarkets have been described as "the new battleground of competition" between traditional banks and new financial institutions. Competition on the Euroyen market has been particularly bloody, as that sector of the market has grown exponentially over the last few years.

Figure 1
New Issues of Eurodollar Bonds, 1978-84



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Threaded throughout these new structures has been the geometric growth of new financial instruments. Indeed, the amount of money involved in "traditional" lending has actually declined over the last several years and is being more than compensated by lending using new techniques:

- *"Securitization"* is overtaking traditional bank loans as the primary means of borrowing. One such new financing scheme—called the note issuance facility (NIF), by which the instrument of debt can be traded away by both the borrower and the lender—grew from near zero in 1982 to an estimated $45 billion last year. NIFs have supplanted syndicated loans—the type given to LDCs before the debt crisis—and along with the new floating-rate notes (FRNs) now account for a quarter of all international loan activity. These instruments were almost unknown in 1980.

- *Currency swaps and interest swaps,* allow investors and speculators to change the currency-of-denomination of financial instruments on short notice. In 1984 $150 billion of interest swaps was executed—a sixfold increase in one year (figure 3). Industry analysts predict that currency swaps will double this year to about $40 billion and cover 25 percent of all nondollar international bonds, up from under 1 percent in 1981.

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- *Combinations of instruments* are creating a dizzying array of new mechanisms of international financing. New acronyms, such as SNIFs, GUNs, and RUFs, are appearing on the Euromarkets every few days. Given the speed of global trading in this new environment, industry analysts report that very few players have even a modest understanding of what many of these new financial contracts involve. It is sometimes unclear, for example, exactly who is on the other side of some of these transactions.

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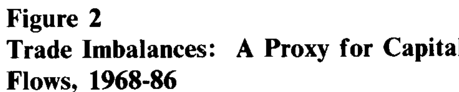
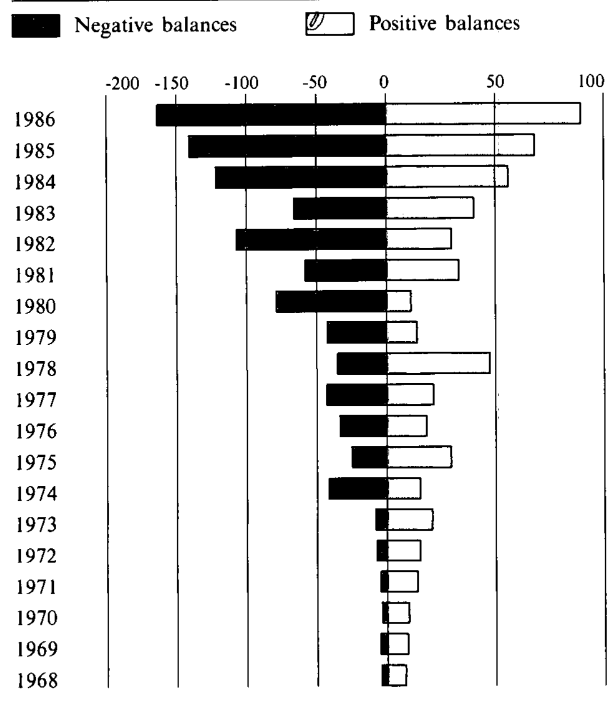
Figure 2

Trade Imbalances: A Proxy for Capital Flows, 1968-86

Billion US $



Note: Trade imbalances must be financed by either a depletion of reserves in the deficit country, or a net inflow of capital through investment or borrowing. The bars on the left side of the chart indicate the sum of trade deficits that were mostly financed by capital inflows through the international system. The constant and explosive growth of these flows through three recession-recovery cycles shows the structural nature of the change. Such trade imbalances would not have been possible without the conduit of the international financial system.

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All of these factors have combined to change the way businessmen think worldwide. Now traders can move massive amounts of funds across borders to take advantage of momentary shifts in exchange rates. Because of the high costs of being caught in the wrong currency during a sudden exchange rate shift, rumors about even relatively small news events can send markets reeling. Over the longer term, businessmen must take the global economy into account when considering what were previously domestic business decisions.

Linkages to the Global Economy

The globalization of financial markets has also played a role in the changes we have seen in the world economy over the last decade. The magnitude of capital shifts that have occurred since 1980 has taken most observers by surprise. For example, few observers would have predicted that the international financial system could deliver enough capital to the United States to support its multihundred-billion-dollar trade and federal budget deficits. Without the flow capacity the capital market has developed, such deficits probably would have driven US interest rates to unprecedented levels; or, more accurately, such deficits would not have occurred. On the flip side, the global market has afforded Japan a new outlet for its surplus capital.

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In general, the capacity the international financial market has given countries to run larger trade imbalances has grown enormously: the absolute level of trade imbalances of OECD economies this year is estimated at more than $250 billion, or 20 times what it was before 1970 (figure 2).

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The ties that have been forged between the international financial market and the various domestic markets have irreversibly linked the monetary and financial policies of governments. Today more than ever, the evaporation of financial borders, coupled with the dollar's role as the world currency, means that the world's interest rates are "set in Washington." Because of the ease with which capital now flows across borders, foreign central banks find it increasingly difficult to pursue an independent policy of, say, lower interest rates: such policies would quickly drive capital to seek higher returns on foreign soil.

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Continued Globalization

We foresee a further acceleration of the globalization process. International banks are in a fierce struggle with each other and with new competitors to expand their volume and scope of business. The technologies that made possible this globalization are likely to undergo more revolutionary advances. These trends, along with the growing competition from the new,

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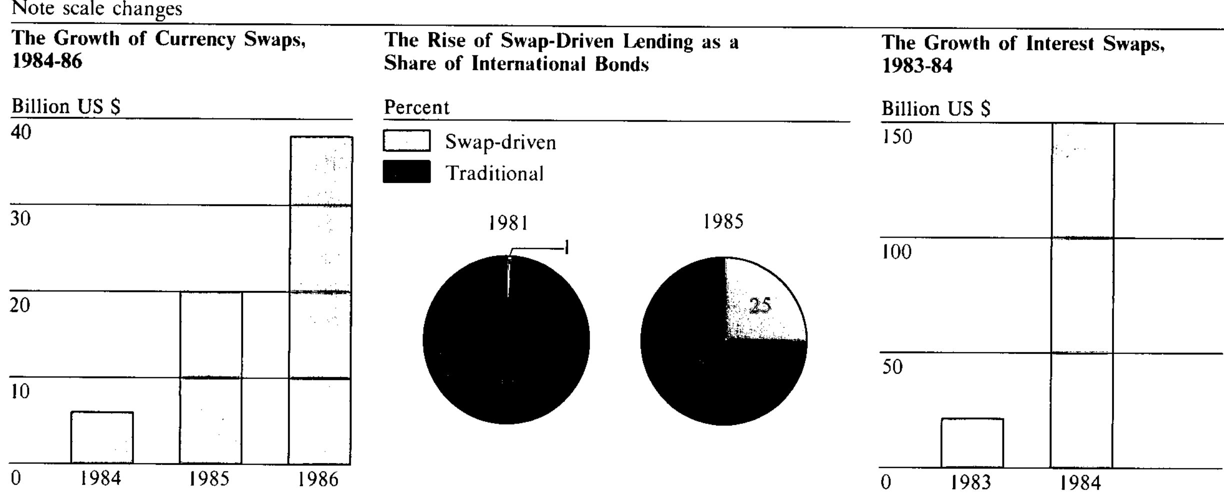
Figure 3
Financial Instruments: The New Importance of Swaps



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loosely regulated money centers in the LDCs, would overwhelm any possible backpeddling by Western governments in their efforts to liberalize the global financial system. Short of global crisis, we see nothing that can stop this process.

Evolving Ramifications

Because the role of the international financial market in facilitating greater growth and efficiency of the world economy is widely recognized, we will focus here on the evolving concerns and opportunities raised by the new financial environment. We believe there are important ramifications on several global issues. Directly, financial globalization has raised short-term economic instability problems for both the market and individual countries. Moreover, it has created opportunities for exploitation of the financial system by groups whose goals may threaten US security interests. In a more indirect fashion, the international financial system has accentuated problems in related areas, including protectionism and US competitiveness, and has generated some national sovereignty problems that may heighten international tensions.

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Short-Term Economic Stability

The international financial market now provides a highly fluid medium through which political and economic shocks in one area are transmitted quickly and forcefully to the rest of the globe. As a result, markets are increasingly sensitive to news. This volatility, in turn, can cause broader economic and political fluctuations, both internationally and within countries through exchange rates, interest rates, and capital flight.

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Where Will the Financial Power Center Be in the Year 2000?

As the international financial system becomes an increasingly important element in the world economy, speculation increases about where the center of the system will be. Observers cite three major contenders:

- London *has historically been the world's financial capital. If an international bank has any foreign offices, it is likely to have at least one in "The City." Strong relations between the British Government and private institutions have kept financiers' confidence high in London's ability to carry the flag. Moreover, the bulk of the growing Euromarket and venture capital activity is in London. The "big bang" deregulatory moves are intended to keep London in the forefront for the foreseeable future.*

- NewYork, *many believe, may have already overtaken London as the real center of power. In the past three years, the combination of US proliferation of innovative instruments and the expansion of the US economy has brought Wall Street to great prominence. The dollar is already considered the global currency. Moreover, New York is outpacing London in creating 24-hour trading rooms and acquiring foreign financial institutions. As a result, New York may be better prepared for the emerging global marketplace.*

- Tokyo *is quickly rising as a financial center and may present a serious challenge to both London and New York in the next decade. The increasing importance of the Japanese economy on the world scene, deregulation of Tokyo markets, and the large surpluses of Japanese capital are likely to catapult Tokyo to a prime position and lead to a rapid internationalization of the yen. Japanese banks' total international lending overtook that of the United States last year—with roughly $60 billion more in assets and liabilities.*

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The idea of physical location for the 21st-century financial power center may be an illusion of 20th-century thinking, however. The globalization of the financial system could result in just that: a "metaphysical marketplace" whereby the true power resides in the electronic links between countries and the dominant currency is the wide array of financial instruments, such as swaps that allow investors to switch back and forth between denominations instantaneously and continually from any location.

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There have been instances of the use of foreign financial decisions to affect political policies in a target country. The most visible example of this is the investment sanctions placed on South Africa by Japan, Australia, Austria, the Nordic countries, and the EC. These sanctions range from divestiture to bans on new loans and investment and are aimed at putting pressure on the South African Government to change its apartheid stance.

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Soviet Financial Breakout

The Soviet Union has recently taken actions to become a more active member of the international financial community—reversing the pattern of relative Soviet isolation from the global financial markets. Moscow is making greater use of the Western financial markets and is trying to join international financial organizations, such as the IMF and the World Bank. We believe this new policy to break into these arenas stems from the broader Soviet initiative to take a more active role in international affairs—particularly in the Third World—and from the sharp decrease in the USSR's hard currency earnings resulting from the oil price collapse.

Evidence in the financial markets indicates that Moscow is testing new financial waters:

- *The Soviets have invited Western banking officials to Moscow to discuss joint financing for medium-term credits and financial paper and have expressed interest in new forms of financial instruments.*
- *The Soviets have expressed interest, since late 1985, in establishing joint ventures with Western firms that could—for the first time since the 1920s—allow direct foreign capital investments on Soviet soil.*

In August the Soviets established a bank in the Cayman Islands—an emerging offshore financial center—to circumvent restrictions that preclude their bank in the Netherlands from arranging floating rate notes (FRNs) and note issuance facilities (NIFs). This move is a significant step toward Soviet use of these newer, more sophisticated financial instruments.

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The Soviet Union is the only major country not currently a member of the IMF and the World Bank. Membership in these organizations would end Moscow's outcast role in the international financial arena; other Eastern Bloc countries—Hungary, Romania, and Poland—already belong to the IMF. Should the Soviets join the Fund, they are likely to receive the third-largest voting share, after the United States and the United Kingdom, which would put them in the position to disrupt the traditional activities of the organization while raising Moscow's level of influence worldwide.

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Foreign exchange rates are the primary mechanism of shock transmission and can reflect—and cause—major changes in other sectors. For example, on 27 February 1986 a rumor spread through the market that there would be an emergency Group of Five meeting to stabilize the US dollar. Within 30 minutes the deutsche mark and the yen dropped more than 2 percent against the dollar. Given the size of outstanding foreign exchange positions, the drop represented a shift in wealth of about $1 billion on the market.

The volatility of LDC currencies can be especially great. The table shows the reaction of exchange rates to selected events of sociopolitical instability within Third World countries. The table also indicates the difficulty LDC central banks have in defending exchange rates in time of crisis. Believing—or hoping—the speculative attack on their currencies is temporary, central banks often rapidly deplete foreign exchange reserves to bolster the exchange rate. Such action is often futile, and within weeks market pressure causes an official devaluation, leaving the central bank seriously drained. This failure, in turn, often feeds further speculative attacks on the currency as traders perceive the central bank too weakened to support the exchange rate even at its lower level.

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Sociopolitical Instability: The Response of Exchange Rates and Central Reserves [a]

	Event	Exchange Rate Drop (*percent*)	Reserves Drop (*percent*)
Mexico			
18 February 1982	Government declares halt to exchange intervention	40	35 [b]
20 August 1982	Government declares a debt principal moratorium	29	62 [c]
7 July 1985/12 July 1985	Midterm election/secret Cartegena meeting	30	20
South Africa			
13 July 1984/15 July 1984	Squatter homes destroyed/rent and tax riots	18	3 [d]
22 August 1984	New parliament elections amid widespread vote boycotting	11	56
20 July 1985	Emergency declared	22	37
Philippines			
21 August 1983	Aquino assassinated	21	51
14 May 1984	National Assembly elections	22	27

[a] The time period for the response is one month, unless otherwise rated.
[b] Month preceding event.
[c] Four months.
[d] South Africa's reserve numbers understate the extent of government gold reserves.

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Interest rates are now more closely linked worldwide than ever before. This stems not only from the increased efficiency of the financial market but also from the large cross liabilities between economies. For example, the London Interbank Offer Rate (LIBOR)—the world's interest rate benchmark—is a primary determinant of changes in Brazil's debt service payments. These payments, in turn, are a significant portion of Brazil's balance of payments (figure 4). A small rise in LIBOR, therefore, puts immediate pressure on the individual debtor economies, the ability of these economies to service foreign debt, and, in turn, the international financial system as a whole.

The damage this can cause is best seen in the Brazilian experience. Despite sometimes severe budget austerity measures, the government deficit has continued to soar. The Brazilian central government's expenditures on goods and services now closely match its revenues. The overall government deficit, however, now absorbs nearly one-fourth of Brazil's gross domestic product because of debt service obligations. A slight wobble in world interest rates is transmitted to the domestic economy, which, in turn, has a large impact on the Brazilian deficit.

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Capital flight from the Third World is facilitated in two ways by the new environment. First, the increased volatility of exchange and interest rates creates strong incentives for individuals in LDCs to quickly move their funds abroad when an event occurs that may affect these rates. Indeed, this has a dangerous feedback effect: the market has become sensitive to capital flight, and this drives down exchange rates even further.

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Second, the globalization of markets has provided an efficient mechanism for the quick, quiet transfer of funds to safehavens overseas. The favorite first stop of

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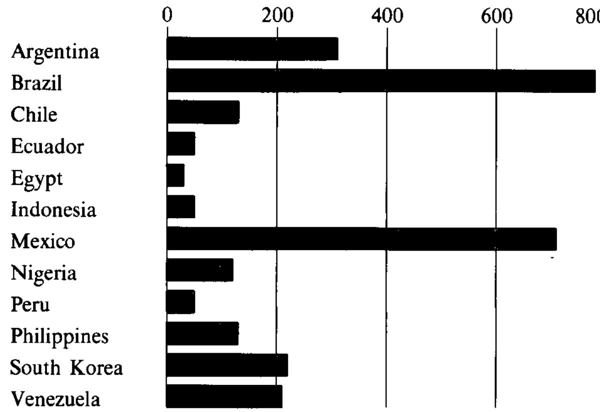
Figure 4
Savings to Selected LDC Debtor Economies From a 1-Percentage-Point Drop in LIBOR[a]
Million US $



[a] Because of their relatively large debt service payments, the health of LDC economies is partly a function of the level of interest rates in the developed countries–principally the London Interbank Offered Rate (LIBOR) and the US Prime Rate.

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these funds is usually LDC offshore money centers. Panama and the Caribbean are heavily used by Latin American individuals and businesses, while Hong Kong is the clearinghouse for much of the flight capital from Asia—particularly the Philippines. The final destination for the money—after it is laundered in these offshore centers—is often the United States. Efforts are also made to convert the liquid assets into real estate or deposits in secure countries, particularly Switzerland.

As a result, the damage done by capital flight has been twofold. In the last decade more than $200 billion has fled the 18 largest LDC debtors, according to Morgan Guaranty estimates. During this same period, and partially as a result of this capital flight, these same LDCs accumulated an additional $450 billion in new debt. Now that the inflow of new capital to LDCs has slowed tremendously, LDC governments are facing difficulty repaying their debts because the $200 billion was not invested in productive domestic assets.

There are some positive aspects of capital flight, however. The $200 billion has been earning returns overseas for citizens in LDCs at a greater rate presumably than that obtainable in the home country. many LDC businesses have used the earnings on their stock of overseas funds to finance operations when domestic funding gets tight. On the consumption side, observers note that repatriated earnings from flight capital often allow even middle-class LDC citizens to maintain living standards above what their purely domestic incomes would allow. Finally, funds remaining overseas represent a stock that could return to boost growth if LDC policies ever become more favorable to domestic investment.

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Financial stability—the strength of the entire system to withstand volatility and occasional crises—is being questioned more within financial circles. Most observers argue that the broadening of the investor base and the enhanced information flows have bolstered the overall system. There are emerging, however, trends in international finance that we believe raise concerns:

- *The sharp competition among lending institutions*, especially after the 1973 oil price hikes, led to what many believe was a steady lowering of the risk threshold lenders were willing to accept. If this trend continues, another global recession could put a raft of debtors in default. Unlike the troubled LDC debtors, these endangered debtors would be decentralized—making a coordinated effort among lenders, creditors, and governments to resolve a crisis more difficult.

- *The declining power of regulators* could also encourage financial institutions to take greater risks. In Hong Kong, for example, where regulation is almost nonexistent, several banks failed last year—causing waves throughout the Asian financial community. On a broader scale, the speed, size, and complexity of markets are reducing the regulatory authorities' ability to foresee potential stability problems and react to them.

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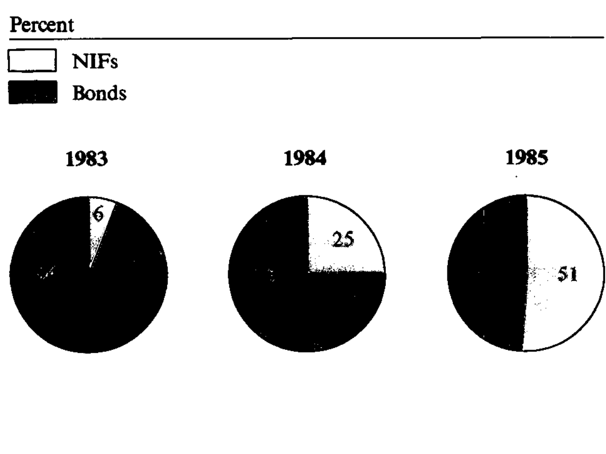
- *The fragility of the financial network* has increased as, at any given moment, the billions of dollars floating in the system are susceptible to disruption. An example of such a disruption occurred in the US banking system in November 1985 when a computer software failure caused an overnight delay in the clearing of a middle-size bank's settlements. As a result, the Federal Reserve quickly lent the bank $22.6 billion to prevent what Chairman Paul Volcker called "potentially serious implications for the payments system and securities markets." Observers emphasize that the rescue mechanism is not as solid for the international funds transfer system.

- *The spread of new instruments* has brought new uncertainties about the risk and underlying value associated with the transactions. Of greatest concern is the exponential increase in note issuance facilities (figure 5). Observers note that many of these instruments do not entail direct liability, as does a regular loan, but simply risk exposure. Currency and interest swaps, as well as NIFs, commit the bank to accept liability only if the market "turns against" the bank's customer. Although the bank earns a fee in the short run, widespread financial panic could overwhelm the international banking community's ability to meet its "triggered" liabilities. One observer wrote that there is a "son of debt crisis" waiting to happen.

Figure 5
The Rise of Note Issuance Facilities: Overtaking the International Bond Market



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Taken together, we believe the most important implication of these stability factors is that a bond has been forged between the financial market's perceptions and the economic and political well-being of individual countries. Before the globalization of finance markets, economies were less tied together, meaning that external events—such as a shift in exchange rates or LIBOR—would have less impact on a country's well-being. Conversely, domestic turmoil would have little impact on world markets. Today, a shock to any element of the global financial web can send repercussions throughout the system.

Exploitation of the International Financial System

Along with the globalization of international finance has come greater use of international financial communications networks and banking facilities by governments and groups whose objectives threaten Western security interests. Aside from the multibillion-dollar international narcotics money-laundering industry, funding of terrorist activities, gray arms purchases, and nuclear proliferation are often accomplished through the world's international financial networks. The governments and groups participating in these activities find the speed, ease, and anonymity associated with use of the international financial system attractive for their purposes. These transactions are normally fully legitimate in form, using international letters of credit and interbank transfers as payment mechanisms, and usually legal in the countries where they are conducted. This enables the arms or proliferation merchant to carry out his business in a conventional manner while using the proven reliability and security of the international financial transfer networks.

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Narcotics. With several billion dollars in earnings to process each month, narcotics traffickers have emerged as key users of the international financial system. The Colombian drug traffickers have used US exchange-house operators and their representatives to establish an underground financial system linking the US market to the northern-tier Latin American countries, the source of some 75 percent of the marijuana and cocaine sold in the United States. By relying on a

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combination of exchange houses, offshore banking facilities, and cash smuggling, the system has been highly effective in shielding the drug-money flow from interdiction by US authorities and in evading exchange controls along the drug-money trail.

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Although methods of money handling have shifted in response to the focus of US enforcement efforts, the pattern of the Colombian drug-money trail has remained fairly stable over time. Miami and New York function as principal collection and disbursement points in the United States. Management of payments to suppliers of raw materials in a number of countries occurs primarily in Colombia. The most important intermediate repository and payment center is Panama, which also functions as a procurement site for goods and services required by the cocaine industry and which may serve as an investment banking center for profits.

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We believe the huge, erratic flows of narcodollars offer pluses and minuses for the countries involved. Directly, the inflow of narcodollars has boosted incomes in recipient countries. Only a small share of the population benefits, however, and much of this money flows back out. Moreover, in those countries where a precarious economic and financial situation has prompted curbs on currency exchange, the availability of cheap narcodollars on the black market can frustrate controls by providing a virtually open door for capital flight. In those countries with free-floating exchange rates, periodic floods of narcodollars can cause the value of local currencies to soar—reducing the competitiveness of all legitimate exports. As the world market for cocaine expands, satellite Colombian drug-forwarding centers are springing up in Western Europe and other affluent areas. As a result of geographic diversification, profit accumulation, intensified enforcement in traditional locations, and growing sophistication, traffickers are beginning to invest outside Hispanic areas—which raises additional political problems.

Terrorism. Among state sponsors of terrorism, the Libyan regime stands out for the size and blatancy of its use of international banking arrangements to finance terrorists.

- Because of its lax banking laws and large Arab population, we believe Nigeria could be a money center for laundering Tripoli's subversive support.

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Ever since the US freeze on Libyan assets, Qadhafi has used interbank transfer mechanisms to send US dollars to terrorists.

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according to Embassy reporting, Libyan nationals transferred a large sum of money from a bank in the United Arab Emirates to terrorists for a sabotage operation in Egypt.

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Governments and individuals involved in illegal transfers of weapons, technology, and nuclear materials also find the international financial system an efficient mechanism to make payments for their goods and services.

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Political Corruption. Corruption by Western standards among political elites in Third World countries—no matter what their ideology—appears relatively commonplace. While the consequences of these activities for Western security interests is ambiguous, they can seriously add to the debilitation of the Third World economies subjected to this skimming. Leaders of countries whose interests have paralleled those of the United States

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have proved in some cases to be as corrupt as leaders of some countries with which the United States has largely confrontational relations. Political elites throughout time have been able to amass personal fortunes. Financial globalization has made it easier for these elites to move their profits quickly and secretly out of the country into financial safehavens and untraceable, but profitable, investments in industrialized countries.

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Commodity Market Manipulation. The sharp rise of funds flowing internationally has increased the possibility that other markets, particularly commodity markets, may be manipulated by governments or individuals who can quickly and quietly draw together funds for their activities. Despite the current commodity glut, some spot markets are thin enough in relation to their associated futures markets to be manipulated—or even cornered.

In February 1982 there was a massive manipulation of the tin market (figure 6). A "mystery buyer" bought an estimated 25,000 metric tons—more than half the existing market stocks—at a cost of nearly $0.5 billion. We suspect this buying was financed by Middle Eastern oil interests on behalf of predominantly Islamic Malaysia—the largest tin exporter. This effort to corner the market failed largely because of actions by the London Metals Exchange (LME), the predominant tin-trading center. But the seriousness of this manipulation lies in its effect on tin prices: the manipulation drove prices to record highs, and its failure pushed prices down more than 20 percent in a matter of days.

A year earlier the LME stepped in and put restrictions on zinc and lead trading when "confusing," highly volatile price movements suggested manipulation of those markets. Again, prices fell when actions were taken to thwart a cornering of the market. Silver, an even larger market, was nearly cornered in the 1970s by the Hunt brothers. The price of silver more than doubled during this episode, then lost more than 60 percent of its value after the attempt failed. More recently, there were rumors that the mid-April 1986 rebound of spot oil prices may have been driven by Saudi activity in the oil futures market.

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The political implications of such manipulations may outweigh the economic consequences. Indeed, in the cases of tin and silver, the manipulators lost money on the transactions when they failed to corner the market. The dependence of Third World economies on commodity prices, however, makes volatility of these markets important to LDC governments. The recent growth in international financial flows has raised the possibility of a group's quickly entering the financial market, obtaining control over a large amount of funds, and then using these funds to enter a commodity spot market. As futures contracts come due, the market could be cornered—which is good for exporters. Or, as we have seen in these other episodes, the group could deliberately or accidently drive prices down—inflicting economic damage on exporting LDCs.

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Exchange Rate Terrorism. We believe that the strengthening bonds between the international financial system and individual countries are raising the possibility of a new terrorist weapon: attacking a country by damaging its exchange rates through a concerted terrorist campaign on its sources of foreign exchange. For example, on 3 April 1986 *The Wall Street Journal* reported that concern was raised in the international financial community over the 2 April TWA bombing over Greece. The specific concern was over the potential foreign exchange losses resulting from a decline in tourism. Egypt is also vulnerable because tourism is its third-largest source of hard currency.

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Although the recent terrorist activity was not to explicitly affect exchange rates, the situation has reached a point where even the threat of a country's being targeted for a terrorist campaign can depress its currency and raise the government's risk premium. Such activity would contribute to a self-perpetuating deterioration of the economy—as is happening in Egypt. Terrorists could use this strategy to target a country at critical times, such as during a debt rescheduling.

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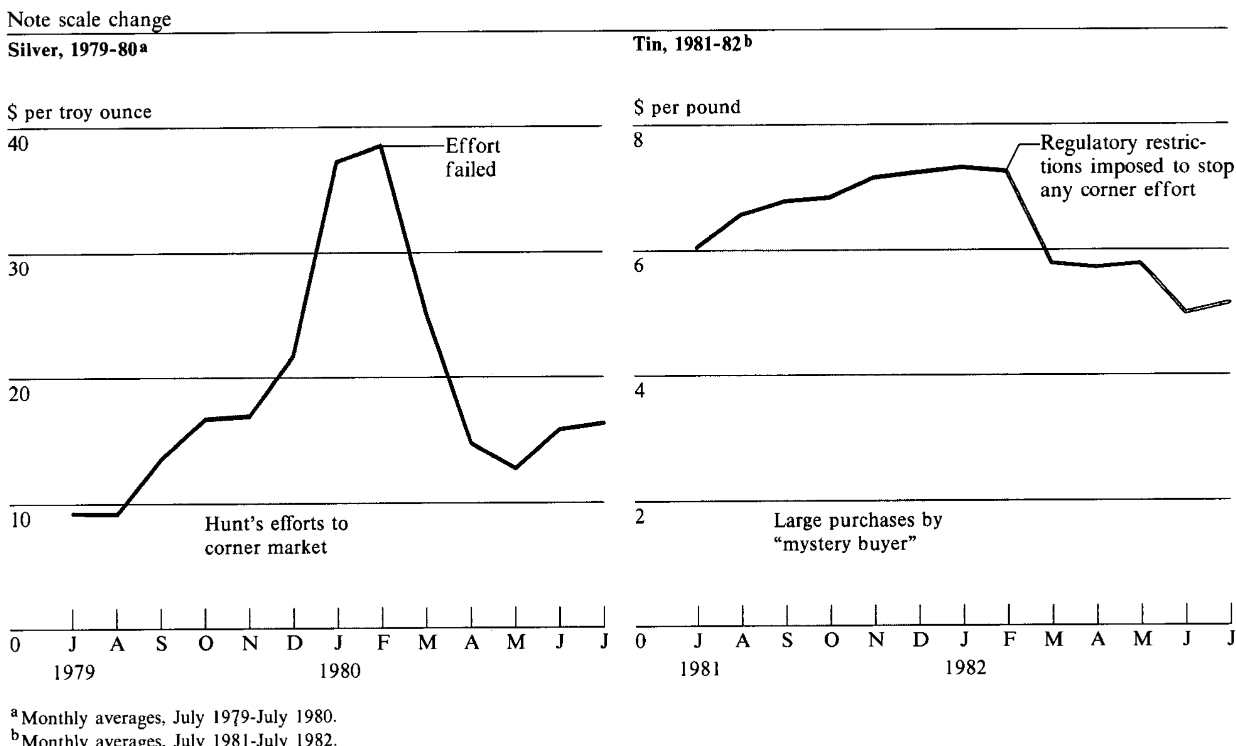
Figure 6
Manipulation of Select Metal Markets



[a] Monthly averages, July 1979-July 1980.
[b] Monthly averages, July 1981-July 1982.

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Assaults on the System Itself. The importance of the international financial system to the world has made the system an attractive target for assault by terrorists or other groups. The billions of dollars flowing through the financial system every hour are vulnerable to disruption or, perhaps worse, manipulation. As discussed above, growing interdependence of the electronic interbank-transfer network increases the severity of a potential disruption. Morgan Guaranty has estimated that the amount of "outstanding" funds on the international wires at midday New York time can reach $100 billion. A serious funds-clearing problem at a major bank could transmit defaults throughout the system. A concerted assault on key banking centers or telecommunications points at a critical time would have even wider consequences.

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The increasingly anonymous electronic nature of the international banking network has also raised speculation that the system is highly susceptible to manipulation—either to deny funds to certain groups or to earn a profit for the manipulating party. Multimillion-dollar foreign exchange transactions between New York and London are made on the basis of a telephone call and a confirming telex—several hundred

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International Financial Communications Networks: Potential Choke Points

The rapidly growing volume of international transactions handled on sophisticated financial networks may be an area of increased vulnerability for the international financial system in the years ahead. Specialized telecommunications systems are capturing an increasing share of this international banking communications and clearing activity. Hundreds of billions of dollars pass through these networks daily in transfers of dollars, pounds, and francs. The failure of such systems could, in our judgment, jeopardize the smooth functioning of the international payments system and the creditworthiness of individual banks.

From a US perspective, the most essential of these specialized networks for international financial activity are SWIFT and CHIPS.

- *SWIFT (Society for Worldwide Interbank Financial Telecommunications) is a standardized global interbank information system. The system transmits such things as customer or bank transfer instructions, foreign exchange confirmations, and reconciliation messages, but it has no clearing mechanism or funds transfer capability. In 1985 the SWIFT system processed an average of 665,000 messages a day between some 1,300 member banks in more than 45 countries, and system use is growing at a rate of 20 percent per year. A larger and more decentralized system, SWIFT II, was scheduled for introduction this year but has been delayed for at least one year.*

- *CHIPS (Clearing House Interbank Payments System) is a computerized network in* New York *that links the major banks for the clearing of international dollar payments. In 1985 this network handled about 95,000 interbank transfers valued at $280 billion daily, some 90 percent of all interbank transfers relating to international dollar payments.*

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Both of these networks are physically and electronically well secured, but nonetheless there is some risk that their operations could be disrupted at some key choke points.

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- *While fully backstopped, damage to the CHIPS' central computer system in* New York *would, at least temporarily, make it extremely difficult for the money center banks to clear their international accounts, jeopardizing their financial condition.*

- *All communications on the SWIFT network involving the United States pass through the network's operating center in* Culpeper, Virginia, *and its loss would also cause temporary confusion in international banking communications. Disruption of SWIFT's other operating centers in* Leidens, the Netherlands, *and* Brussels, Belgium, *would also broadly impact SWIFT network operations, but would have less impact on those activities involving US banks.*

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times an hour. The speed and volume of such funds transfers could make tracing any accounting anomaly very difficult—and certainly time consuming—even if they were discovered.

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Some Broader Connections

Looking at the longer term, the globalization of financial markets has speeded the flow of resources worldwide. As is the case with the United States over the past few years, imports now can be drastically increased without a concomitant rise in exports—with the difference being funded by capital transfers. This change, along with the growing importance of the service sectors, has caused capital movements to overtake trade patterns as the principal determinant of economic power balances. The fallout from the redirection of capital flows through the financial system since 1982 has shaped the global economy and spawned many of the considerable problems we see today. In particular, changes in capital markets have

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a significant impact on two central issues—the Third World debt problem and the globalization of industry. Through its impact on these developments, the financial globalization also affects such key issues as trade imbalances and protectionism.

Internationalization of Production. Through its impact on exchange rates, financial globalization is influencing the shift of industry and technology from one country to another. Although underlying profitability remains the driving force behind these shifts, the dollar exchange rate is an important variable, determining where profits are highest. The problem is that massive capital flows boosted the US dollar's value substantially higher than would have otherwise been the case. In this environment, many of the previously competitive US operations were moved overseas or closed down.

While the linkages to financial factors including exchange rates are not well defined, industrialized economies—especially the United States—are experiencing the impact of internationalization of production. In mature industries:

- The major *commercial aircraft* companies continue to seek foreign partners not only to defray the huge development cost and risks associated with the launching of new designs but also to assure an entree to their partners' market.
- Increasing linkups of *automobile* firms have been spawned by market access restrictions and the need for low-cost production bases. In Western Europe, financial pressures are forcing automakers to increase the use of cooperative ventures to achieve economies of scale and to rationalize production.
- Growing international competition has led to a shakeout of *machine tool* producers. Small, marginal producers are dropping out, and US firms have sought links to Japanese and West European competitors to survive.

Although most visible in the mature industries, the same process is rapidly occurring in the high-technology sector:

- Many *semiconductor* firms, particularly in the United States, are dropping out of the high-volume memory market and/or forming joint ventures with Japanese or European firms because they are unable to continue the high investment in research and development (R&D) and capital equipment with shortening life cycles.

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- To survive, once fiercely independent *computer* companies are scrambling to form alliances and partnerships to broaden their product ranges. Moreover, R&D costs have become too large for most computer firms to bear alone.
- In *telecommunications,* growing deregulation and rapid advance in technology are prompting dramatic changes in the structure of the industry. Firms are forming alliances to offer complete product lines and services at competitive prices and to gain access to restricted foreign markets.

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The motivations for entering strategic alliances can differ widely across countries, industries, and companies. Not only economic factors, such as exchange rates, but also government trade and investment policies play a major role. In general, the Japanese are increasingly entering international alliances to maintain or improve market access while tempering protectionist sentiment. For their part, West European governments and firms have banded together in regional R&D programs, such as EUREKA and ESPRIT, to regain competitiveness and greater independence. At the same time, however, many large European firms, such as Olivetti and Philips, have formed alliances with US and Japanese firms to acquire product and process technologies to gain access to their markets. US companies, squeezed by high capital costs, low profits, and foreign competition, are looking abroad to defray R&D and investment costs.

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Third World Debt. The LDC debt buildup that accelerated in the late 1970s was in part made possible by the globalization of financial markets. In particular, it became increasingly easy for Third World parastatals as well as private companies to tap capital markets. Third World parastatals were especially aggressive in this regard. We estimate that these entities accounted for the lion's share of the Third World debt buildup during the late 1970s and early 1980s. In some Third World countries, Brazil for example, parastatals accounted for all or most of the government's budget deficit as well as the bulk of foreign borrowing.

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The capital flight discussed earlier combined with the repayment needs associated with past heavy borrowing represents the principal drain on Third World financial resources. The response has included import restrictions by LDC governments to save foreign exchange for debt service payments and so-called critical imports. As the crisis hit, total LDC imports fell 7 percent—the first drop in nearly a quarter century—with nearly 60 percent of the reduction concentrated in debt-troubled LDCs. The imports of these countries fell $24 billion—nearly 18 percent—in the first year of the debt crisis alone. The impact was greatest in Latin America—which is closely linked to the US economy—where declines of about 40 percent were reported by Argentina, Mexico, and Chile. The resulting contraction of Western exports led to a decline in developed country import capacity and spread debt problems to other, previously sound, LDCs.

While vastly expanded financial networks helped accommodate growth in Third World debt, the closure of capital markets to many Third World countries is forcing major policy changes. In many respects this highlights the vulnerability of domestic policy to developments in capital markets. Specifically, because they cannot borrow what they need, a growing number of Third World countries are finally paring once unconstrained spending programs, reducing the role of parastatals, and, in some instances, encouraging foreign investment for the first time in decades. More than anything else, these policy adjustments reflect the domestic impact of foreign capital market decisions over which the LDCs have little or no control. Five years ago, largely unlimited access to those same capital markets enabled Third World countries to finance economic statism.

Trade Deficits and Protectionism. Ironically, while the dearth of capital and foreign exchange in the LDCs has contributed to protectionist sentiment, the large inflow of capital to the United States from Japan and Europe has also strained trade relations as the US trade deficit expanded. The trade imbalance has focused attention on the import restrictions that exist in countries with which the United States has large trade deficits—particularly Japan and the newly industrializing countries (NICs). The nearly $50 billion, US-Japanese trade imbalance in 1985 is the largest on record, Japan's overall trade surplus of over $50 billion annually, however, is both a friction point and a major source of international financial liquidity.

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On the Atlantic side, the United States and Western Europe are competing for shares of several declining—but still important—world markets, such as steel and agriculture. The US share of the world market for five key agricultural commodities slid from 54 percent in 1980 to 41 percent last year. The European Economic Community (EC), also feeling competitive pressures, implemented protectionist policies in 1985 that may cost the United States more than $1 billion in lost agricultural exports. Again, the LDCs have played an important role by no longer being a ready outlet for OECD goods, and by actually emerging as new competitors to OECD exporters. Indeed, the LDCs' share of the world agricultural export market has risen in the last five years from 10 to 17 percent, and we expect LDCs to increase their steel output by 35 percent by 1990 (figure 7).

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Globally, according to a World Bank report, the rise of protectionist sentiment in developed countries in this decade may have made protectionism more respectable. These forces could very well undermine the coming new round of the General Agreement on Tariffs and Trade (GATT). The last GATT round, which was negotiated with some difficulty, occurred in a much more favorable economic environment: world trade was rising rapidly and there was healthy growth in imports by the LDCs, the East Bloc, and the developed West. These conditions are now absent. Now governments feel pressure to "lock in" their market share through protectionist actions.

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Policy Interdependence. An emerging political issue is the increased economic interdependence that has resulted from the financial globalization and the associated growth of industrial integration. As discussed above, the United States is becoming more dependent on foreign countries for some manufactured goods and many of its key strategic technologies. Other countries are facing similar issues, which may strain relations with US allies and other governments important to the United States. As domestic financial markets around the world become integrated

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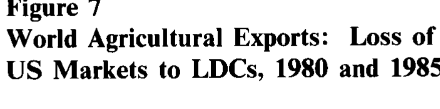


Figure 7
World Agricultural Exports: Loss of US Markets to LDCs, 1980 and 1985

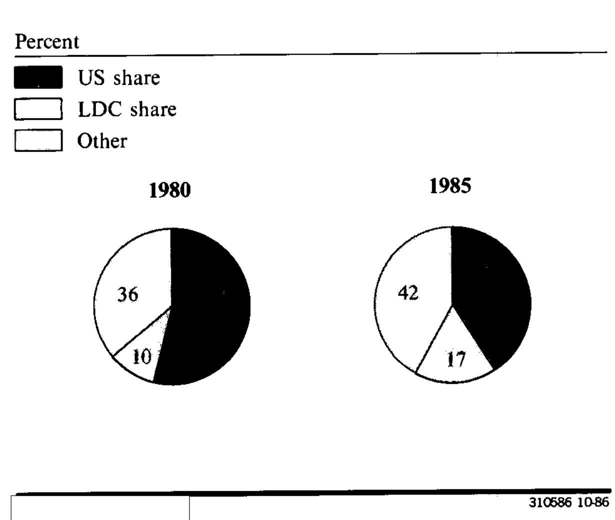
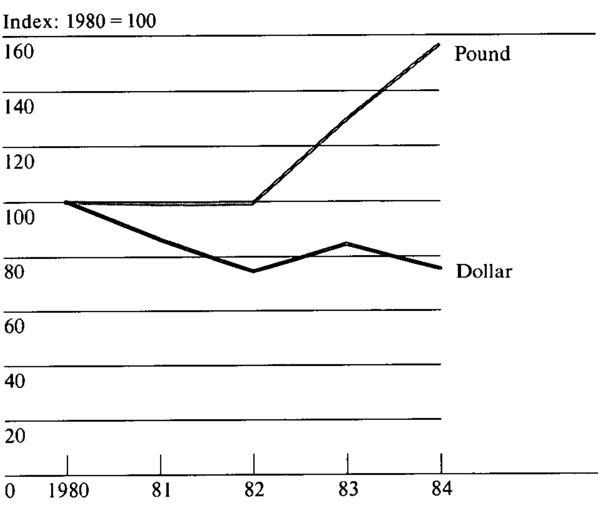


Figure 8
Commodity Price Indexes: British Pound vs. US Dollar, 1980-84



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with the international financial system, foreign governments find it increasingly difficult to formulate and execute their own, independent monetary and fiscal policies. Moreover, the dominating influence of the dollar in the world economy, coupled with the transmission effects of the international markets, has put US economic policy in the limelight. As a result, US policy has frequently come under fire by allied governments and has been repeatedly raised at discussions during recent economic summits.

West Europeans have been complaining since the early 1980s that high interest rates in the United States have drained Europe of capital, dampened investment there, and hampered their monetary policies. They attribute these high rates largely to the burgeoning US budget deficit. Although European central banks are not powerless to control interest rates in their own countries, they fear that reducing rates on their own in an attempt to stimulate growth would result in a flow of capital to the United States. Some West European governments also fear that a stimulative policy would ignite inflation rather than growth in their countries. They believe the result would be scarcer capital in Western Europe and upward pressure on interest rates. Consequently, European leaders blame the United States for boxing them in to tight, low-growth policies. LDCs have faced similar problems and have blamed the United States for interest rates that raise debt service payments and encourage capital flight. These debtors have raised US economic policy as an issue in North-South discussions on the debt problem.

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The strong dollar increased the import bills faced by European economies dependent upon dollar-denominated commodity imports. As the rise of oil prices eased in dollar terms between 1980 and 1985, the strength of the dollar continued to push oil costs up for Europe and Japan. Other commodity prices also rose sharply despite price drops for US importers (figure 8). The dominance and volatility of the US dollar has, at times, added to the difficulties faced by central banks in the operation of the European Monetary System—a priority with EC governments—which has caused some friction between the United States and Europe. Illegal immigration of Mexicans into the United States has been fueled in large part by

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the strong dollar—a point Mexican authorities have not overlooked in their discussions with US officials on this politically sensitive issue.

At the industry level, the greater integration of capital markets has reduced the government's control over its productive base. The rise of multinational corporations has speeded the response of the free market to any one government's attempt to put restrictions on a company's activity. Previously, when international capital flows were smaller, capital-intensive manufacturing industry grew in capital-rich countries. Today, low wages and a favorable regulatory environment have become the dominant factors in location decisions. Such competitive pressures have undermined efforts in developed countries to institute environmental, health, labor, safety, and strategic-production regulations; the subjected companies simply move to a less restrictive environment. For LDCs, such shifts have drained capital from economies where the policies are heavyhanded or ill conceived.

Frustrated by this loss of power, governments may react with shortsighted nationalistic policies. On a popular political level, there may be a rising tide of protectionist sentiments—this time on foreign investment. Japanese capital has been moving into businesses in the United States and Europe, both by building new plants and by acquiring stock in existing companies. Europe, despite its recent privatization efforts, may expand efforts to keep European industry under European ownership—while keeping European capital on European soil. A stated policy of the large-scale, European technology development programs, such as EUREKA and ESPRIT, is to keep technology investment at home, rather than letting it go to the United States or to the NICs.

In another example, in the wake of the Westland and British Leyland affairs, the US Embassy in London reports that sentiment is rapidly rising that US investment in the United Kingdom is "excessive." The Embassy believes that a bid by a US firm for a prime British financial institution after the "big bang," or a plant closure by a US firm, would cause political troubles for the Thatcher government. Paradoxically, the opposition Labor Party has pointed to capital outflows from the United Kingdom as a no-confidence vote on Tory economic programs by the international financial markets.

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Regional Perspectives

From a regional perspective, the evolution of the international financial scene will be a key determinant of the strategic political and economic positions of countries worldwide. The financial markets will continue to play an expanding role as the foremost medium through which interactions between the regional groups occur. The increasing integration of the domestic markets with the global markets, moreover, implies that the international flow of resources will become even more important to the domestic stability and political orientations of individual countries.

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We believe there are two key issues that will determine the impacts of the international financial system on the various regions:

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- *The direction and magnitude of capital resource flows to and from the region.* The past few years have demonstrated that the flow of resources into, or out of, a given region can reverse almost overnight and cause widespread shocks—both regionally and globally. Recent examples are the rapid shift of resources from the developed West to OPEC, and in turn to the Third World. The current flow of capital from Japan to the United States has fueled the US economy as the engine of growth for the entire world. Future flows of capital facilitated by the globalized financial system are likely to be quicker and at least equally as important.

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- *The extent to which the region participates in the system.* In the past, some countries participated fully in the global financial markets—such as Europe and the United States—while others participated only tentatively—such as the USSR. As the importance of the financial system grows, countries will find it increasingly costly to abstain from becoming involved. Those governments that try to remain apart will find themselves on the periphery of international economics and politics—"Albanias" of the international community.

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Regardless of the impact on a given region, the central position the United States occupies in the global scheme means that US interests will be closely linked to the regional consequences of the evolving worldwide financial situation. [ ]

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Appendix

The Global Financial System: The Future Role of the Major Players

This appendix examines briefly the future role of the major players—Japan, Western Europe, the Third World debtors, the Middle East, the Soviet sphere, and China—in the global financial system in terms of level of participation and the impact on US policy. A list of selected related publications for each area is included.

Japan

Japan's role—both in terms of providing capital and financial services—is likely to remain of major importance to the evolution of the world economy.

Resource Flows

Excess savings at home and high interest rates abroad have turned the Japanese into huge capital exporters. Net overseas asset acquisition has increased rapidly during the last five years so that the stock of overseas financial assets at the end of 1985 was nearly $440 billion—70 percent of which was held in the form of long-term assets, according to Japanese Government statistics.[1] Indeed, long-term US Government securities have been a favorite of Japanese investors in recent years—primarily because the high yields and long maturity of the bonds are attractive to Japanese insurance companies and pension and postal funds that have long-term liabilities to cover.

Japan is likely to remain an excess saver and thus a large capital exporter at least through the early 1990s. In addition, we believe that numerous factors—including international pressure—will compel Japanese policymakers to accelerate the pace of financial deregulation during the rest of this decade. Such deregulation will, among other things, allow financial institutions to hold a larger share of their growing portfolios overseas. For example, the Finance Ministry's recent easing of regulations governing the holdings of foreign securities by Japanese insurance companies, trust banks, and small financial institutions could quickly boost their holdings of foreign securities by $25 billion, according to Japanese Government estimates.

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Participation

As a result of large capital flows and financial liberalization, Japanese banks and securities companies are playing larger roles in the international financial system. Already, four of the five largest banks in the world are Japanese. In 1982 only two banks had more than $100 billion in assets and both were US banks. By 1985, however, the number of banks with assets over $100 billion had grown to 12—six of which were Japanese. Likewise, Nomura Securities is already the world's largest securities house and is rapidly increasing its presence in both the New York and London markets.

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In our view, further deregulation of the financial system will aid the efforts of the Japanese banks and securities houses that are determined to be as successful in exporting financial services as the Japanese firms were in capturing international markets for manufactures. For example, the opening of an offshore banking center in Tokyo this December may over time shift business from the established Euromarket in London and international banking facilities in New York, Singapore, and Hong Kong to Tokyo—although strict regulations will initially limit the scope of the offshore market's activities. In addition, the Japanese will almost certainly garner a larger share of the international bond underwriting market. In fact, Japan's four big securities houses are working diligently to convince the US Federal Reserve Board to grant them primary dealerships in US Government bonds.

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US Policy Implications

US financial institutions are likely to feel the brunt of this new competition from Japanese banks and securities houses. Aggressive behavior and success on the part of these institutions may lead to tensions between

[1] Japanese net foreign assets at the end of 1985 were nearly $130 billion.

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Washington and Tokyo similar to those that now exist over auto parts, machine tools, and telecommunications.

Nevertheless, Japanese purchases of US securities, as well as direct investment in the United States, indicate to us that the Japanese have a long-term interest in the US economy. Indeed, the Japanese stake in the United States is broad based, and increasingly Japan's own prosperity—in the form of profit repatriation, exports, and interest earnings—will be geared toward the health of the US economy.

The growing importance of the US economy to the Japanese suggests that the Japanese Government will play a key factor in influencing the behavior of Japanese businessmen in the United States. For example, we believe that if Japanese investors move to sell off securities in large quantities—a move that could in several years drive up US interest rates and thus choke off investment and economic growth in the United States—Tokyo would quickly apply pressure such as administrative guidance to prevent such a rapid shift in Japanese portfolios. Japanese investors would be tempted to ignore Tokyo's desires if they felt that their US investments were seriously threatened—an expectation that could develop, we believe, from an international financial crisis.

In any case, Tokyo's official approach to overseas investment bears watching. Just as Tokyo will closely watch its investments in the United States, we believe that Japan's foreign policy may become more geared toward protecting its increasing investments in developing countries. For example, Japan in time is likely to demand a political role in multilateral institutions, such as the World Bank and the International Monetary Fund (IMF), that is equal to its growing financial contributions to such organizations.

Western Europe

Most of the major financial issues that Western Europe will face over the next decade will represent a continuation of the financial difficulties it has undergone over the past decade. But unlike the first half of the 1980s, which buffeted Europe with a strong dollar, the primary exchange rate issue may very well be the possibility of a further decline of the US dollar from its 1985 peak.

Resource Flows

Net capital flows from Western Europe in the early 1980s—a major factor in the dollar's rise—substantially affected the West European economies. The reduction in the supply of capital in Europe created upward pressure on domestic interest rates, which cut investment and—to a lesser extent—consumption. Whether this was net minus, however, is uncertain because the strong dollar has also helped European growth by making exports more price competitive. A dollar decline could stall economic growth because the governments largely have relied on exports to stimulate economic expansion without taking meaningful structural adjustment measures in other sectors. Inflation would decline, but unemployment would increase. The European Monetary System—which undergoes stress with a movement of the dollar in either direction—may face difficulties if the dollar is volatile in the future. With the increased globalization of markets, the dollar-yen relationship also has strong impacts on the European economies. An appreciation of the yen against the dollar will shift Japanese exporters' attention to European markets.

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Participation
Because Europe is already at the center of the international financial system, the extent of European participation in the system is not likely to change a great deal. Important linkages between the European economies and the international financial markets have been strengthened in the past several years, however. Heavy borrowing by 12 West European governments—notably France, Spain, Greece, and Belgium—has made foreign debt a critical factor in the European outlook. Between 1978 and last year, this debt nearly doubled and now stands at around $400 billion.

This debt is a double-edged sword. On the one hand, it is an often overlooked aspect of the fragile international debt situation; the amount of outstanding European public debt rose as fast as that of the LDCs and is only half as large. This puts added pressure on the system, and there is a possibility a spark from Europe could set off the financial crisis observers thought might originate from the Third World. On the other hand, this debt—which is 80 percent dollar-denominated—puts the domestic economies of Europe more at the mercy of the international economy via the world interest rates. We estimate that for every single-percentage-point increase in LIBOR, European annual debt servicing probably rises almost $3.5 billion. Moreover, these effects will be transmitted quickly because of the heavy European use of a new financial instrument—the floating rate note (FRN)—which varies the interest payments with LIBOR.

US Policy Implications
The importance to the United States of the financial well-being of European economies can be seen in a number of arenas:

- *Trade.* A further weakening of the dollar would put severe strains on the US-EC trade relationship. A strong dollar has boosted European exports and helped keep down the cost of the EC's massive agricultural subsidy program. Already, we are seeing increased trade friction on this front. This could very well spread to other sectors and undermine the upcoming GATT round.

- *Political orientation.* The current conservative governments of northern Europe are likely to face increased opposition pressure if they reduce the popular social-spending programs in their attempts to restrain budget deficits and strengthen the role of the private sector in the economy.

- *Defense spending.* These governments may, as a result, further shave their defense-spending goals. NATO countries have already fallen short of the 3-percent annual growth rates agreed upon for the 1980s. Consequently, the United States would be called upon to carry a heavier burden in the defense of Europe.

- *Solidarity toward the East.* Weaker finances in Western Europe could easily lead to a greater willingness on the part of these countries to expand trade with the Soviet Union and Eastern Europe. Such action could undermine allied technology-denial efforts such as COCOM—as occurred during the Soviet pipeline construction. Moreover, the West Europeans may step up offers of subsidized credit to the East to finance such trade.

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As in the past, the dependence of the European economies on the dollar, US-led world interest rates, and US trade will mean that these issues are likely to continue to dominate US-European dialogue, as diplomatic pressures are put on the United States to formulate its economic policies with Europe in mind.

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The Third World

Of all the regions, the Third World has been the most affected by the evolution of the international financial scene. The foreign debt situation has become the most important single influence on both the economic and political stability of many LDCs critical to the United States. The massive inflows of capital to the developing regions in the last decade were abruptly halted and, in many cases, have been reversed as LDCs must run large trade surpluses in order to send the capital surpluses back to the developed West to service their debts.

Resource Flow

Although the growth of the Third World foreign indebtedness is likely to slow, the financial problems are not expected to diminish during the remainder of the decade. In our judgment, a major obstacle to an improved financial outlook is the potential reduction in the net flow of financial resources from Western and OPEC sources. Aside from credits extended in conjunction with IMF and World Bank adjustment and rescheduling packages, new commercial bank lending to the Third World is expected to remain minimal through 1990. The rate of growth of commercial bank lending to the major debtors will be curtailed by reassessment of the Third World creditworthiness, among other factors. Moreover, the majority of medium- and long-term lending will go almost exclusively to the relatively low-risk East Asian countries.

Participation

As a result of these pressures, we believe that the LDCs' attitude toward foreign investment will gradually improve. As the competition for foreign investment intensifies, many of the Third World countries can be expected to pursue foreign investors more aggressively by offering substantial investment incentives. The incentives offered are not expected to attract a substantial amount of foreign investment, however. In an attempt to retain some control over incoming funds, we believe many countries may impose performance requirements, such as export quotas, employment targets, and local content requirements, which are a major deterrent to potential foreign investors.

Again, much of the direct foreign investment is likely to be concentrated in the safer investment climates of Asia. At the other end of the spectrum, the poorest LDCs will continue to rely on official loans and grants for nearly all of their financing. As a result, we believe the economic prospects for the very low-income LDCs—particularly in Africa—are not going to improve in the near future. In the middle lies Latin America, which is likely to continue to muddle through, with periodic financial crises that are not likely to severely upset the international financial system.

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US Policy Implications

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These wide economic and political differences will cause an increased stratification of the Third World—with a consequent divergence in the various groups' relations with the United States. The NICs and the second-tier exporters of East Asia are seeking to further penetrate OECD markets with high-value-added manufactures. The other developing countries face onerous debt burdens and feel that some accommodation with creditor governments on debt relief is a necessary condition for future growth and domestic stability. Meanwhile, many Sub-Saharan African countries need massive aid to stave off economic disaster. As a result, US policymakers will face different groups with differing agendas. The Cartagena group of Latin American debtors is one example. Other countries could begin collective action around such issues as concessional aid or access to US markets for LDC manufactures. Because these interests tend to be identified with specific areas of the world, we expect to see Latin America focusing on debt, the Africans on aid, and the Asians on protectionism.

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In formulating their own policies, Third World governments will be forced by the tightening links between their domestic economies and the global financial system to reduce their interventionist tendencies:

- As discussed above, attempts to maintain overvalued currencies are becoming more difficult as the financial globalization process allows the market to

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overwhelm such policies by quickly draining central banks' hard currency reserves. The pressure is increased by the market's perception that long-term overvaluation is unsustainable, which also encourages capital flight.

- The rise of black foreign exchange markets, itself a result of financial internationalization, also undermines heavyhanded government rules. The US Embassy in Buenos Aires estimated that two-thirds of the value of currency circulating in Argentina is in US dollars—critically undermining any monetary or fiscal policy the government tries to take independent of global market conditions.

- Because the debt situation has made the export sector critical for many LDCs, governments are taking steps to rationalize the trade sector. Authorities have raised prices for export products in an effort to boost production, devalued their currencies, and attempted to bring inflation down closer to the world level.

And finally, the economic success of the relatively free market approach practiced by the NICs has not gone unnoticed by those LDCs that were badly burned by the debt crisis.

Domestically, many LDCs will face serious political obstacles to taking the necessary steps toward servicing their debts while resuming sustainable economic growth. The key determinants of political reaction to prolonged austerity are how much the citizenry expects of governments, and the flexibility of the given political systems. Where expectations for governments are low, or where the population dares not push for change, strong political reaction to economic hardships is less likely. This is likely to be the case in much of black Africa and South Asia. When governments can successfully deflect much of the blame from themselves to predecessors, international banks, the IMF, or the United States, they can escape the potential fallout from political pressures or political instability. Thus far, the governments in Mexico, Venezuela, and Argentina have managed to deflect much of the blame. Brazil's return to civilian government has given Brasilia a grace period, and it seems to be using it well. The Philippines and Nigeria have both been subject to regime changes stemming from culpability of the leaders for economic problems.

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Regardless of the true capability US policies have to determine the future well-being of the Third World, it is important to note that both the governments and populaces of the LDCs, particularly those in Latin America, view the United States as being of overwhelming economic importance. As discussed earlier, LDCs are straining under the burden of US dollar-denominated debt, have heavy imports of dollar-denominated grain and oil, and therefore target US markets for their exports to acquire US dollars. Moreover, there is a growing recognition in LDCs that the United States is the prime source for the investment and technical skills necessary for sustained growth. Although these linkages often result in political pressures on the United States, they also make US policies toward the Third World far more potent than those of other countries. Despite the problems faced by such US initiatives as the Baker Plan, the United States remains the only country capable of taking the lead in affecting Third World economic and political behavior.

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Middle East

The financial future of the Persian Gulf will be primarily shaped by the future of oil prices. And by extension, the economics and politics of the entire Middle East will be significantly affected by the volume of financial flows through the Persian Gulf.

Resource Flows

The large current account surpluses of the Persian Gulf have evaporated. Although Kuwait and the United Arab Emirates are likely to continue to survive on current revenues, Saudi Arabia—the economic engine for much of the region—began drawing on its huge external assets in 1984 when its 1983, $16.3 billion current deficit rose to a $20 billion deficit. The Saudis have also begun to cut expenditures. In contrast to the peak OPEC years, the Middle East on balance is likely to be a net capital consumer through at least 1990.

Other countries in the region are suffering a double blow from the reduced oil prices. Directly, non-Gulf states, such as Egypt and Syria, are also facing falling oil revenues. Indirectly, many of these countries depend on Gulf states for aid and economic stimulus through trade. Pakistan and Egypt, for example, depend heavily on foreign exchange sent home by expatriate work forces in Gulf states. Many of these workers are now being sent back—further swelling the underemployed populations of cities like Cairo.

Participation

The Saudis, despite a roughly $100 billion foreign asset base, are not likely to continue to draw down these reserves at the current rate. Riyadh has stepped up its borrowing from Western sources in recent years in an effort to maintain both spending and assets. A large accumulation of floating-rate debt, however, would link the Saudi balance of payments to LIBOR—a linkage that the Saudis would have to consider before taking any action to raise oil prices, which would boost worldwide inflation and interest rates. Regardless of whether Riyadh chooses to borrow or draw down on external assets, capital would be pulled from Western Europe—further dampening investment and growth in that region.

Egypt is also likely to increase its participation in the international financial system—by going to the IMF and the Paris Club to seek debt rescheduling. Egypt's 1986 estimated drop in revenues roughly equals its debt service payments. A rescheduling would almost certainly entail a cut in domestic food subsidies. We believe this could dramatically increase the likelihood of civil disorder and widespread rioting if handled badly by the politically weak Mubarak regime. Moreover, anti-Western sentiments, already on the rise, could skyrocket as the populace views the economic readjustments as capitulation to foreign, and particularly US, pressure.

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US Policy Implications

The drop in Saudi revenues could particularly affect US interests in the region. Saudi Arabia's primary means of responding to regional pressures is foreign aid, which Riyadh uses to reward moderates and placate radicals, but in both cases encourages consensus. Saudi Arabia is the world's second-largest aid donor, after the United States. Much of this aid has gone to serve overlapping US-Saudi interests in the region. For example, Saudi aid has strengthened Jordan, Pakistan, Turkey, Somalia, Morocco, Lebanon, Bahrain, and Oman, and the Afghan and Eritrean resistances.

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Conversely, there has been a steady flow of Saudi aid to Syria and the PLO

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Libya too may find itself unable to buy influence with other Third World countries as revenue shortfalls erode its ability to send economic and military aid to a wide range of countries

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Both Iran and Iraq, moreover, will find it increasingly difficult to finance large offensives as their protracted war drags on.

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The Soviet Sphere

Known Soviet activity in global financial markets is almost exclusively linked to facilitating trade flows. The soft world oil market is sharply cutting Moscow's export earnings and, by implication, Soviet financial flows in international capital markets over the next few years. Although the dollar magnitude of Soviet transactions may fall, the scope of Soviet financial activity will probably expand as Moscow increases the use of new international financial instruments to maximize the return on its smaller pool of funds.

Resource Flows

The USSR uses the international banking system to transfer funds in support of its bilateral transactions. Payments are made either directly through Vneshtorgbank, the Soviet Foreign Trade Bank, or one of six Soviet-owned banks in the West. In addition, Vneshtorgbank and these Soviet-owned banks are active players in the interbank market.[2] Because of their short-term nature, the Soviet deposits are probably used to facilitate financial transactions rather than to provide a net of new funds.

Moscow also taps international credit markets to finance trade. Declining Soviet export revenues since 1984 have resulted in increased borrowing activity. The USSR's net borrowing increased by about $4 billion last year, raising total net debt to $14 billion—quite small compared with the world's major debtors and the size of the Soviet economy.[3] In addition to taking advantage of short-term borrowing and supplier credits, the USSR has raised about $2.8 billion in syndicated loans. Heavy borrowing continued during the first half of this year—we estimate that the USSR arranged more than $1 billion in syndicated borrowings—as Moscow sought to offset the sudden decline in oil revenues as oil prices plunged. Moscow may also be taking advantage of favorable interest rates to lengthen the maturity structure of its debt to the West.

Although Moscow's initial response to its deteriorating financial position resulted in increased activity on financial markets, the long-term adjustment could work to reduce Soviet involvement. The Soviets already are moving to decrease imports to redress the financial imbalance, with Foreign Trade Minister Boris Aristov stating that imports from the West could be cut by one-fourth to one-third this year. We estimate that, even with average net new borrowing of $1 billion per year and increased gold sales, the USSR will have to reduce annual average imports through 1990 by 30 percent in real terms from the 1984 level.

Participation

The inherent conservatism of Soviet managers has made them relatively passive players in the international banking arena and leery of adopting many of the new international financial mechanisms. In addition, an appreciating dollar and rising revenues from oil sales during the early 1980s reduced the need to tap these secondary financial markets. With fortunes reversed, there is some evidence that the Soviets are willing to test new financial waters:

- Vneshtorgbank invited officials of two major French banks to Moscow in June to discuss joint financing for medium-term credits and financial paper. The bank was also interested in using new financial instruments in its international operations.

[2] The Soviet-owned banks were established to facilitate Soviet trade with the West. In addition to handling many routine trade transactions, these banks place interbank deposits in Vneshtorgbank and extend credit to the USSR. Their activities are reported to and regulated by the host countries.

[3] The depreciation of the dollar increased the dollar value of the Soviet debt to the West by about $2 billion.

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- The Soviets may be becoming more attuned to the impact of foreign exchange movements and are looking for ways to offset the effect of the dollar depreciation.

- Moscow also appears on the brink of expanding the scope of bilateral relations. Since late last year the Soviets have expressed interest in establishing joint ventures with Western firms that could—for the first time since the 1920s—allow direct foreign capital investments.

- Soviet acquiescence last year to an acceptance facility in a syndication with US and Canadian bankers reflects greater Soviet flexibility in light of hard currency problems.

Soviet-owned banks in the West are beginning to adapt to the new condition in the global banking community, in part as a response to changing demands of their Western customers. These banks are participating in currency swaps, debt swaps, and interest rate swaps. Moscow Narodny Bank, for the first time, recently launched some floating rate note instruments. One consequence of the globalization process would be to provide a less expensive and less visible way for the USSR to acquire funds—by using the vast interbank market more aggressively than it has to date.

US Policy Implications

With the volume of Soviet trade and financial activities likely to decline, US banking activity with the USSR will probably also contract from an already low level. While US banks may look to the USSR for new lending opportunities—US banks participated in commercial loan syndications last year for the first time since the invasion of Afghanistan—the US preference for trade financing will limit the extent of such activity. Should the USSR permit joint ventures with Western firms, US banks may help finance US participation in such ventures, although this type of financing probably carries higher risks than traditional trade credits.

Increased competition among West European firms for the reduced number of Soviet contracts could undermine US efforts for a unified Western policy for lending to the USSR. Western governments, anxious to maintain the competitiveness of their nations' exports, could become more receptive to pressures for low interest rates and longer repayment terms. The Soviets are currently demanding interest rates of no more than 7.8 percent and have even pressed for rates under 7 percent in negotiations for government-backed project loans. On commercial borrowings, the Soviets will probably continue to obtain loans at margins slightly over LIBOR as long as Western bankers perceive the USSR as an excellent credit risk and opportunities for lending elsewhere remain limited.

Nonetheless, the hard currency shortage could put pressure on Moscow that would benefit US foreign policy interests:

- *Economic initiatives.* Soviet planners will need to revise the five-year plan to account for reduced imports. Moreover, should current efforts to boost productivity and efficiency falter, they might consider bolder economic reforms to carry out Gorbachev's ambitious capital renewal policy without drawing heavily on resources slated for defense.

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- *Western involvement in the Soviet economy.* Prior to the fall in oil prices, Soviet planners, including Gorbachev, were reportedly considering altering the nature of the relationship between Soviet entities and Western firms to enhance the effectiveness of the technology and equipment that the USSR will be able to afford. They recently have shown an interest in joint ventures entailing Western profit sharing and managerial presence, closer engineering and production consultations with Western firms, and the creation of more training facilities with Western participation.

- *Political relations with the developed West.* We believe the Soviets will consider ways—short of real concessions on significant political or security issues—to foster a climate conducive to attracting cheap government-backed credits and Western involvement in the Soviet economy. The Soviets could consider, for example, toning down anti-US rhetoric, relaxing restraints on Jewish emigration, and allowing expanded intra-German ties. Flexibility would be strongly constrained, however, by an expressed Soviet policy aim of reducing long-term vulnerability to Western economic leverage.

- *Relations with Eastern Europe.* Moscow is likely to increase pressure on its East European allies to fill some of the gap in hard currency imports; it may also divert some of its oil exports away from the region. But Eastern Europe is not in a position to provide support on the scale that the Soviets require. Moreover, as falling oil prices reduce the value of planned Soviet exports to Eastern Europe, the latter will be in a stronger position to resist Soviet pressures for increased exports.

- *Relations with the Third World.* Moscow's policies toward the Third World, including its clients, are not likely to be significantly affected. The hard currency component of military and economic aid has gone only to Cuba [redacted] [redacted]. We expect the Soviets to be more aggressive on the international arms market, including an increased willingness to part with state-of-the-art arms and to provide military technicians, in order to boost hard currency sales. [redacted]

From their perspective, Soviet-supported LDCs and Eastern Europe are likely to find greater benefits from participating in the Western financial system. Mozambique, for example, has strengthened its Western financial ties by joining the IMF and World Bank in 1984. Moreover, Maputo has signed an investment insurance agreement with the United States and has recently solicited private investment from US and other Western firms. The increased participation in the Western financial system by governments within the Soviet sphere could also encourage greater use of free market mechanisms domestically. In the case of Mozambique, the government has distributed state-owned land to private owners and has returned some nationalized manufacturing firms to private ownership as part of its effort to lure Western money. In the long run, such trends strenghten Western influence to the detriment of Soviet ties. [redacted]

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[redacted]

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China

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The direction of the Chinese economy, and its impact on the international trade and finance markets, could well become one of the most important issues in the last half of this decade. [redacted]

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Resource Flows
Last year China's outstanding foreign debt stood at $5.7 billion. Official commercial borrowing has been limited as the Chinese have focused on borrowing for development purposes, often at concessionary rates. Although traditionally Beijing is fiscally conservative, China is seen by many Western observers as a potentially mammoth importer of capital to finance its long-term development. China has one of the highest credit ratings of any country and would be welcomed as a customer by nearly every Western financial institution. Should Beijing suddenly decide to take advantage of its borrowing power, capital-flow patterns from Japan could be radically altered.

Participation
Even barring such a scenario, Beijing has been taking significant steps toward attracting more foreign investment. The central Chinese Government has offered tax holidays and is providing more decision-making autonomy for foreign ventures there. Moreover, China has tried to expand its offshore leasing program for petroleum rights.

In the international financial sector itself, China in 1997 is to take political control of a prime Asian financial center—Hong Kong—although it nominally plans to permit economic autonomy. Already, China has a very visible financial foothold on the island. In Hong Kong there are branches of the Bank of China and its 12 associated banks, 31 other financial institutions, and five insurance companies. These institutions are using Hong Kong as a training ground for managers and a test market for financial instruments that have yet to be offered on the Mainland. They have performed very well; financial journals report that the Bank of China has outdistanced many European- and US-owned banks in some areas and is facilitating trade and financial ties between the international markets and the Mainland. Many bankers predict an ever-increasing amount of investment funds for China coming from the world markets through the Hong Kong connection.

US Policy Implications
Increased Chinese activity in the international markets—whether through heavy borrowing, by allowing increased foreign-investor access, or by becoming a major financial broker—would be likely to enhance Chinese influence throughout Asia. Control of Hong Kong, moreover, is likely to give Beijing greatly enhanced information on—and leverage over—individuals, groups, businesses, and countries conducting their financial transactions through the island. Hong Kong is a preferred financial center for trade—both legal and illegal—for the Pacific Basin, as well as a magnet for regional investment and flight capital.

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