

CAPITAL MOBILITY, INFLATION, AND HARMONIZATION

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Financial rules and institutions should be evaluated in terms of their effects on the real economy. My brief paper makes three simple points:

- A global market for financial claims is a necessary but not sufficient institution to ensure the mobility of capital among nations or the protection of capital in one nation.
- A reduction of inflation *increases* economic growth within a few years.
- Global markets, in most cases, are better served by global competition in rule making rather than by global rules.

For some, these conclusions may seem so nonintuitive that they must be wrong. My guess is that, within several years, these conclusions will seem so obvious that people will wonder why they were ever at issue.

Mobile Capital and Capitalism

It is important not to let our thinking become captive to our rhetoric. Capital is the set of natural resources, hardware, software, skills, cultural attitudes, and institutions that increase output per worker. Most existing capital is not mobile unless it is quite literally on legs, wheels, wings, or can be transmitted electronically; most old capital is still vulnerable to exploitation by those who control the powers of government in the immediate area. New capital is increasingly mobile among nations only in that more people and firms are prepared to consider investing in some other nation.

In an important sense, however, capital is *less* mobile among nations than during the century prior to World War I. During much of that

period Britain maintained a net capital outflow of over 5 percent of GDP, and much of that investment was in what we would now call developing countries. During the past few decades international capital flows have increased rapidly but are still a lower share of national output than a century ago, and most international investment is now among the developed countries. A study by Robert Zevin (1992: 51–2) of the U.S. Trust Company concludes that “every available description of financial markets in the late nineteenth and early twentieth centuries suggests that they were more fully integrated than they were before or have been since.” The difference is that the set of conditions that attract investment—secure property rights, low and nondiscriminatory taxes, limited and transparent regulation, etc.—are *less* widespread than a century ago even if somewhat broader than a few decades ago.

Most of what we call capital today, however, is not capital but various types of financial claims to capital. And indeed, the market for these financial claims is increasingly global; many of these financial claims can now be marketed in many nations almost instantaneously and at a declining transactions cost. The breadth and efficiency of financial markets are important to economic performance, but the state of the financial markets should not be confused with the state of the capital markets. A stock exchange is often regarded as the symbol of a capitalist economy but may be only “a field of dreams” unless the other conditions are in place to attract investment in that economy.

The globalization of financial markets will make the price of similar financial claims more nearly uniform among countries and is a proper focus of attention by financial entrepreneurs and financial economists. By itself, however, the globalization of financial markets will have little effect on the monetary, fiscal, and regulatory policies of individual governments. The increased mobility of *capital* among nations, however, will severely discipline the ability of governments to impose costs on the owners of capital that are higher than the value of the services provided by the government. This is likely to lead to some leveling down in the discriminatory taxation and regulation of capital and some shift of taxation to less mobile labor. For that reason, many governments will oppose the conditions that increase the mobility of capital. For that reason, any government that promotes the conditions that attract investment creates a worldwide public good for the owners of capital in all nations. For that reason, the prospect for maintaining a capitalist economy in one nation depends on the opportunities to invest in other nations.

Death of the Phillips Curve

The reduction in the inflation rate in the G-7 countries, I suggest, is primarily a consequence of a condition that economists do not

understand very well—learning from one's own experience and that of others. Specifically, my sense is that most politicians have finally learned that there is no long-run Phillips Curve. Indeed, the U.S. experience suggests that the unemployment rate is a *positive* function of the inflation rate within several years. My own simple estimates suggest that the current U.S. unemployment rate, as expected, is a negative function of the current inflation rate, but is a stronger positive function of the inflation rate and the unemployment rate in the prior year; this implies that the unemployment rate is a weak *positive* function of any steady-state inflation rate.¹ This result is consistent with the hypotheses that any inflation reduces the signaling efficiency of changes in relative prices and that people spend time and real resources to hedge against inflation.²

The reduction in inflation is a result of increased independence of the central banks and of market forces, I suggest, only in that learning has led politicians to cede greater authority to their central banks and that the market response to prior monetary policies contributed to the necessary learning.

The Danger of Harmonization

On the case for international harmonization of financial regulations and accounting standards, I am very suspicious. The Basle standards on bank capital, approved in 1988 by a cartel of central bankers and fully implemented by the end of 1992 without any domestic review or legislative authority, are my case in point. These standards, I suggest, were (and are) both unnecessary and ill conceived. In the United States, these standards contributed to a massive substitution of U.S. government securities for commercial and industrial loans by commercial banks that continued through 1993—a condition that probably contributed to the strange recession of 1990–91, the weak early recovery, and the election of Bill Clinton. The Basle standards were the

¹For the 40-year sample, 1954–73 and 1977–96, for example, a least-squares regression yields the following estimate:

$$U = 2.353 - .677I + .862I_{-1} + .479U_{-1}$$

(.407) (.110) (.114) (.068)

$$\bar{R}^2 = .832, \text{ S.E.R.} = .583, \text{ D.W.} = 1.922, \text{ where}$$

U = the unemployment rate for civilian workers, and

I = the inflation rate; GDP implicit price deflator used for 1954–59, and GDP chain-linked price deflator for 1960–96.

A regression on the later 20-year sample yields almost identical estimates and a much tighter fit.

²A recent report of the U.S. Joint Economic Committee summarizes a number of other studies with similar conclusions (Keleher 1997).

wrong response to a real problem—the conflict between national deposit insurance systems and the regulation of the capital standards of foreign banks by their home country governments. Instead of applying a national treatment standard to banks, the standard to which foreign firms in other industries are subject, the cartel of central bankers chose to implement international bank capital standards that eliminated any competition in the setting of standards and conveniently restricted the penetration by Japanese banks in the U.S. and European financial markets.

Some international harmonization of accounting standards seems equally unnecessary but less threatening. Any lender has the authority to ask that the accounts of a would-be borrower be prepared to a specific standard as a condition for approving a loan. Similarly, any government has the authority to require that any bank seeking deposit insurance maintain its accounts to a specific standard as a condition of providing deposit insurance. The primary effects of an internationalization of accounting standards would be to facilitate the international micromanagement of banks and the empirical research by financial analysts.

Those who promote international financial and accounting standards play on a genuine concern about the international financial effects of a severe financial problem in one country. On the surface, these effects seem too small to merit the measures considered. In recent years, for example, Japan and Mexico have each experienced a severe financial problem with few effects in other countries other than on those who had purchased the securities of these countries. Although this observation seems to have been refuted by the recent “Asian financial crisis,” I still believe that the contagion effects of a financial crisis in one country are generally small. As expected, the International Monetary Fund is trying to reinvent itself again—in this case to manage the international response to these national problems. So far, fortunately, no one else seems very interested in the IMF proposal.

References

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