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# International Finance and the Developing World

## The Next Twenty Years

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**Abstract**

Much has changed in international finance in the twenty years since UNU-WIDER was founded. This paper identifies five broad contours of what we might expect in the next twenty years: the flow of capital from ageing societies to the more youthful economies of the South; the growth in the financial services industry in emerging economies and the consequences for their capital flows; the current strength in emerging market debt, and whether this represents a change in fundamentals or merely the effect of low global interest rates; the impact of globalization in goods markets in lowering inflation expectations, and therefore global bond yields; and the implications of the adjustment in global imbalances between Asia (in particular China) and the United States for emerging bond markets as a whole. The paper ends by noting the paradox that today we see ever larger amounts of capital flowing across the globe in search of superior investment returns, and yet the financing needs of the poorer countries are still largely unmet.

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## 1 Introduction

In August 1986, the year after UNU-WIDER began its work, the Institute hosted a conference to honour the memory of Carlos Díaz-Alejandro. Nearly twenty years on it is instructive to look over the resulting conference volume, *Debt, Stabilization and Development* (Calvo et al. 1989) to see how the world has, and has not, moved on. The book contains much discussion of whether a truly global market in capital has emerged, as well as the real effects of capital flows on developing countries—both areas of major debate today. Latin America's deepening debt crisis and the effects of the 'first generation' of reform programmes then underway across the developing world also featured. The terminology of 'emerging economies' was not yet common coin (the first retail fund for emerging markets did not list on the New York Stock Exchange until 1987), and the major global macroeconomic imbalance was between the USA and Japan (not China). Moreover, the acceleration in financial globalization via the new information technologies was only just beginning; Raj Kumar and Joseph Stiglitz (1989: 442) in their paper on sources of technological divergence between developed and developing economies write of '… greater talk about computers in Silicon Valley'.

Much has changed over twenty years. Funds investing in emerging market bonds and equities are taking in record amounts, and the pensions of Mr and Mrs Virtanen (Finland's Mr and Mrs Smith) now in part depend on the prospects for Chinese sovereign debt.[1] But much also remains the same, in particular Africa's plight. In the mid 1980s Africa was undergoing the first of many structural adjustment programmes, some of which worked and many of which failed dismally—resulting in the debt accumulation that has been one of the big concerns of recent years. UK finance minister, Gordon Brown proclaims the need for a new 'Marshall Plan for Africa' but this call first went out in the 1980s.

In 1985 new events and crises were just around the corner: notably the Japanese financial bubble and subsequent collapse; economic transition and meltdown in the communist world; the Asian financial crisis of 1997-98 and the rapid integration of China into the global economy (resulting in trade tensions that have now come to the fore). These outcomes were largely unforeseen twenty years ago. So it may seem reckless to try and make predictions about the next twenty years. Nevertheless, speculation about the future is irresistible, not least to see how far one gets it wrong when we look back from the vantage point of 2025—the year in which UNU-WIDER will celebrate its fortieth anniversary.

[1] In 2004, Finnish pension funds accounted for 7 per cent of the €4 billion of orders for a €1 billion Chinese government bond—their first significant purchase (Guerrera 2004).

International finance and the developing world is necessarily a very large subject, and therefore I confine myself to only some important aspects, leaving many others for discussion elsewhere—thus, on official aid flows see Addison et al. (2005); on new and innovative sources of development finance see Atkinson (2004); and on foreign direct investment see Asiedu (2006). The aspects that I do cover are as follows: the implications of ageing in the 'North' for investment in the 'South'; the expected growth in the financial services industry in emerging economies and the consequences for their capital flows; the impact of the present low levels of global interest rates on emerging market debt; and the impact of globalization in goods markets in lowering inflation expectations, and therefore global bond yields, and the implications of China's rise for this story. I close the paper by noting the paradox that today we see ever larger amounts of capital flowing across the globe in search of superior investment returns, and yet the financing needs of the poorest countries (and the world's poorest people) remain largely unmet.

## 2 Ageing and global capital flows

An ageing world population is a certainty, barring some catastrophic health shock such as a global influenza pandemic which would disproportionately affect the elderly. Fertility rates are falling almost everywhere and life expectancy is rising, with the exception of sub-Saharan Africa (SSA) countries with HIV/AIDS rates; people over the age of 65 will account for 16 per cent of the world's population by 2050, up from 7 per cent in 2000. These powerful demographic forces are now reshaping the global economy, not least in the area of finance where ageing influences cross-country savings rates (and therefore international flows of capital) as well as the rates of return that pension funds can expect (through the impact of ageing on economic growth).

Economic growth in the ageing societies of Europe and Japan will slow as workforces decline, unless labour productivity rises to compensate. Increased immigration (by no means certain) will be insufficient since an inconceivably large number of young immigrants are required to maintain the present ratio of workers to pensioners. The economies of Europe and Japan will therefore shrink relative to countries with younger populations, notably Brazil, India and the USA. Countries with young populations have a 'demographic window of opportunity' that gives them a potential advantage in the global economy, lasting until their present cohort of young workers retires. Investing retirement savings in these economies may therefore generate superior returns to those from investing at home, thereby pushing capital towards the former.

This is a seductive story and a popular one in the financial investment industry (not least in their sales pitch to investors) and for the North's retirees it is increasingly compelling since returns on annuities have fallen sharply (in the UK by almost two-thirds since 1990). This reflects rising life expectancy and a fall in yields, especially on government bonds which make up a large amount of pension fund assets (increasingly so after the

equity market correction of 2000-03 which raised the deficits of company pension funds, leading them to reallocate from equities to bonds). In the UK case, the fall in yields on long-term gilts has been spectacular and real long-term interest rates are now around 1 per cent (their lowest level in 50 years). The fall in yields is self-reinforcing as pension funds are forced to bid up gilt prices (thereby reducing their yield) since their liabilities are calculated using a discount rate based on the long-gilt yield (and the present value of future liabilities rises as yields fall). The yield on US 30-year inflation-protected bonds, a key investment for US pension funding, is now below 2 per cent, and 10-year US treasury yields hover around 4 per cent. This makes the 8 per cent yield on a Brazilian 2040 note very attractive, to take just one example.

However, resolving the North's pension problem by investing in the youthful South is not without problems. Perhaps the most fundamental is that regions with the youngest populations face the greatest difficulties in accelerating growth, notably SSA and North Africa. This might provide an incentive for Northern countries to increase official aid if aid raises growth (by financing infrastructure to stimulate higher rates of private investment in sectors employing young workers, for example). Investors then benefit from higher returns in equity markets, and find corporate debt more attractive. If aid helps to improve fiscal institutions and thereby raises the ability of poorer countries to manage their public finances, then their sovereign debt is more attractive to international investors. The associated improvement in macroeconomic stability would also reduce the exchange rate risk that foreign investors face in purchasing financial instruments, both private and public, denominated in local currencies. But nobody is yet making these arguments for aid in policy circles, and while there appears to be a positive relationship between aid and growth, there remains a very active debate about exactly how much more aid countries can absorb and effectively use (Killick 2005; Sachs 2005). Therefore, while we can expect to see more Northern investor interest in the 'exotic' financial markets of the poorer South, this is likely to be a slow and somewhat tentative process, notwithstanding the benefits of diversification that these markets offer, an issue that I discuss shortly.

The countries that are most attractive to Northern investors are those enjoying high growth, but many of these also have ageing populations, notably China, where retirees now outnumber new workers and there will be four retirees for every ten Chinese workers by 2030 (the ratio is presently one-to-three). This implies a growing pool of domestic savings chasing the returns in domestic financial markets, and China's state pension fund is itself increasingly investing overseas.

Equally important, high growth does not convert automatically into higher returns for portfolio investors. China's stock market has fallen to its lowest point since 2000 despite annual GDP growth of close to 10 per cent. Natural-resource rents that flow overwhelmingly to state-owned oil companies account for much of the Middle East's present growth, not the private sector raising capital for investment via equity and debt

markets (which would employ the region's very young population). And more generally, the returns to foreign investors depend upon foreign exchange risk (itself partly a function of a country's macroeconomic policy) as well as the quality of corporate governance, especially the protection of minority shareholder rights.

Investors must also put a sufficiently high proportion of their portfolio into the emerging market asset classes to benefit significantly (making allowance also for investment fees which are typically high). But investors hold more of their wealth in domestic assets than standard portfolio theory would predict (Lewis 1999), a 'home bias' that may now be starting to decline (see the next section) but one which remains strong nevertheless. Pension funds are also limited by law in the amount that they can invest in financial assets that are less than AAA investment-grade. Diversification towards emerging markets is traditionally thought to reduce the overall variance of a portfolio otherwise consisting of developed-country bonds and equities, but this may be less true in today's world of increasingly integrated capital markets, in which correlations between markets are declining. Nevertheless, diversification towards *smaller* stock markets in low-income countries may still reduce the overall standard deviation of a portfolio consisting of bonds, developed country equities, and the larger emerging markets. Collins and Biekpe (2002) find that most African stock markets, with the exemption of the larger markets of Egypt and South Africa, did not experience contagion during the 1997 Asian financial crisis, for example.

Finally, in the North it is the wealthy that have the greatest interest in emerging markets and obviously the greatest ability to invest and to take the risks implicit in the potentially high returns, not the poor who have the fewest pension assets, and generally the least investment knowledge. North-South capital flows are therefore unlikely to constitute any part of the solution to poverty among the elderly in the North, who will almost certainly continue to rely on their often meagre state pensions.

In summary, the story is more complex than that put out by the investment industry which has its own (highly profitable) reasons for encouraging flows into its emerging market funds. With these caveats in mind, and for investors willing to take the plunge, the range of emerging market assets is widening, and this trend seems set to continue, with the following categories of particular interest:

- *Municipal bonds.* The need for infrastructure investment—in telecommunications, power, and roads—in the developing world is considerable, amounting to US$465 billion annually, or 5.5 per cent of their GDP, from 2005-10 (Fay and Yepes 2003: 17). International emerging market bond funds now include municipal bonds, mainly from Latin America, and there must be scope for raising capital in this way for SSA's infrastructure, thereby reducing dependence on official aid (Leigland 1997).

- *Corporate bonds.* Firms in emerging economies have traditionally relied on retained profits and bank loans for investment finance, but issuing corporate debt could be attractive to international investors searching for yield. However, international investors find the smallness and illiquidity of these markets unattractive. India's market is growing but remains small and fragmentary and afflicted by regulatory weakness, for example (Guha-Khasnobis and Kar 2005). Nevertheless, some middle-income countries have been able to interest global investors in their corporate debt markets.
- *Property.* Emerging market property is a potential asset class for the future, although international investor interest is confined to a small number of (mainly Asian) countries at present. There is a chance that mortgage loans from microfinance institutions (MFIs) could be bundled into securitized assets and sold internationally, since the connection between MFIs and formal financial institutions is at last increasing, at least in some countries (see the next section).

## 3 Southern financial services and capital flows

Financial services are growing rapidly in Brazil China, India, and Russia; by 2010 China's financial services sector will be as large as Italy's and will exceed Germany's by 2020 (Goldman Sachs 2003). Restructuring of domestic financial services featured in 'second generation' reform programmes, with the privatization (either in whole or part) of state-owned banks including recapitalization by foreign banks in some cases (although a number of countries still limit foreign investment). This process has not been straightforward, banking crises have been unexpectedly frequent, and the impact on domestic investment and growth receives mixed reviews.[2] Nevertheless, foreign investment in this sector looks set to accelerate especially in Latin America[3] and in China which the big global banks see as a very attractive market.

Intense competition in mature financial markets and the fall in global interest rates have cut bank profit margins. Their profitability rests on borrowing short and lending long, but the compression of the spread between long-term and short-term interest rates (the flattening of the yield curve which we discuss further below) is forcing international banks to accelerate their search for new and growing markets. The interest rate spread between savings and lending rates is now less than 1 per cent in developed economies but remains up to 4-10 per cent in emerging economies. The latter is also falling as international banks enter the market, thereby deepening domestic financial systems, but banks then expect to profit from providing mortgages, mutual funds, insurance and credit cards, the demand for which is expected to rise with the growing middle class in

[2] For scepticism see Stiglitz (2002: 69).

[3] See Guillén (2000).

emerging economies. Locally-owned banks that succeed in becoming international players will also drive down transactions costs and expand the range of services. This growth will have some major consequences for capital flows, including:

- More finance for mergers and acquisitions at home and abroad by the most successful emerging market companies which are turning themselves into international companies. The rapid expansion of India's Mittal Steel, now the world's largest steel company (and based in London and Rotterdam), is a foretaste of what will happen.

- Mutual funds and pension products, and their growth through increased investment abroad, a trend encouraged by a loosening of limits on their allocations to foreign assets (the Chilean case, for example).

- Growth in Islamic financial products, a US$200 billion market (these instruments do not pay interest, but are structured in such a way that the holder receives a rental income on the underlying assets). Bahrain, the Gulf States, and Malaysia are selling Islamic financial services globally, and the middle-class in Africa (a region with more Muslims than Christians) is a small but expanding market.

- Increased competition is reducing the high transactions costs of making remittances; Western Union has cut its fee to US$10 on a US$200 transfer from the USA to Mexico. Remittances are growing rapidly as 'talent' becomes more mobile internationally (Solimano 2005). The World Bank estimates the annual value of remittances at US$95 billion but the true figure could be two or three times greater—it is difficult to guess how much flows through the *hawala* and other informal transfer mechanisms (Solimano 2004: 177-99).

- Greater connections from international capital markets to microfinance institutions (MFIs) eventually turning microfinance into a viable asset class for international investors. The first step is connecting MFIs to the domestic (formal) capital market. In 2004 Citigroup/Banamex helped Mexico's Compartamos (Latin America's biggest provided of microfinance) to raise the first slice of a US$45 billion (peso denominated) bond from Mexican institutional investors. An IFC 34 per cent guarantee on the bonds helped them achieve an AA investment grade rating by Standard & Poor's. Tapping into global private equity also offers a direct route to international capital; Prisma Microfinance Inc of Boston funds MFIs in Central America this way. Leveraging remittance flows by using them to back bonds to finance mortgages for house purchases by recipient families is another innovation which may become more important.

- Reduced transactions costs, and increased speed, in making cross-border philanthropic transfers to NGOs, humanitarian agencies and (increasingly) direct

to individuals and communities. We can expect growth in flows of charitable donations from emerging economies with a rising middle class. Chinese individuals and companies donated some US$15 million for Asian countries hit by the 2004 tsunami disaster, for example.[4]

In summary, these are trends to watch for the future. Yet they are not without problems. Much depends on whether fast growth is sustained in the emerging economies, with China being critical to what happens next (see later discussion). Moreover, the increase in portfolio flows through increasingly sophisticated financial sectors will make it trickier for policymakers to manage the macroeconomic effects of capital flows.[5] And a fundamental challenge is to encourage inflows to poorer countries (in part by deepening their domestic financial markets), and reducing the exclusion of the poor from formal financial markets (and therefore indirectly from access to international capital).

## 4 Global interest rates and capital flows

One big difference with the world of twenty years ago is the cost of money; in 1985 the US was just coming out of its adjustment to the round of sharp rate rises begun by Federal Reserve Chairman Paul Volcker in October 1979.[6] Fast forward to the present and the yield on the 10-year US Treasury note is around 4 per cent compared with 15 per cent back in the early 1980s. The real (inflation-adjusted) cost of money has fallen substantially. In the UK the long-term real rate is around 1 per cent, having varied between 2 and 4 per cent for much of the last 25 years.

From 2000 to 2004 the US Federal Reserve (Fed) loosened monetary policy in response to the bursting of the tech-stock bubble (1996-2000) and the 9/11 terrorist attacks. The Federal funds rate, charged on overnight loans between banks, eventually reached 1 per cent in 2004, its lowest rate since the 1950s. The Fed went into reverse in June 2004 with the first increase in the Fed funds rate in four years, marking the start of 14 successive quarter-percentage point increases to 4.25 per cent as of January 2006. The Fed has signalled further increases, although the market consensus at the start of 2006 was for a pause after one more quarter-percentage point increase. However, while the Fed has raised short rates, the long end of the yield curve has actually fallen—thereby flattening the overall yield curve—and the yield on the 10-year US Treasury note is now below its level at the start of the Fed credit-tightening cycle. This is a 'puzzle' that is now exercising the market's best minds (see further discussion below). Bond yields are also at all-time lows in the six-year-old euro zone—the yield on 10-year German bunds

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[4] Source: 'Japan, China Enter New Era of Giving', *Wall Street Journal*, 11 January 2005.

[5] Which can sometimes be destabilizing; see Griffith-Jones et al. (2001).

[6] Cooper and Little (2000: 77-121).

is around 3.2 per cent—and long yields are close to 1 per cent in Japan, reflecting price deflation over the last decade.

With global monetary easing, the prices of all major assets—equities, bonds, and property—are now substantially higher than two years ago, and emerging market equities and bonds are amongst the strongest performing asset classes. The JP Morgan Emerging Markets Bond Index Plus (EMBI+), which is the industry benchmark for US funds investing in emerging market debt, returned 8.01 per cent in the 6 month period up to 28 February 2005, easily beating the paltry interest on any money market account. Large inflows from institutional and retail investors have occurred over the last five years, particularly pension funds as noted earlier and this provides a level of market support which was largely absent in the past.

The risk premium on emerging market debt has also fallen with improvements in the public finances of emerging economies; this is partly a consequence of the commodity-market boom itself resulting from strong growth in China and India. In mid 2005, EMBI+ spreads over US treasuries were at their lowest level (338 basis points) since 1997 (just before Russia's sovereign default). Half of the countries in EMBI+ now have an investment grade credit rating, which is unprecedented in the history of emerging market debt.

What does the future hold? A rising Fed Funds rate is typically adverse for high-yield debt markets, emerging bond markets included. If you believe that 'push factors' (global capital supply) are more important than 'pull' factors (emerging market characteristics) in determining the flows into and out of emerging market debt—and there is increasing evidence that the former are more important than the latter[7]—then a rising Fed Funds rate does not bode well for the future. Moreover, the recent reversal in the dollar's fortunes (at least against the euro) reduces the relative attractiveness of non-dollar investments for both long-term US investors (to whom emerging markets have been sold as a way of playing the dollar's decline) and short-term investors engaged in the 'carry trade' (borrowing in US dollars to invest in non-dollar assets). Some market participants believe that the carry trade has created a major over-pricing of risky assets, emerging market debt included, as investors 'reach for yield'. This is consistent with a view that 'fair value' is only rarely seen in a market whose swings depend upon herd behaviour and momentum trading. The carry trade started to unwind in 2004 as the Fed raised rates although it has recently resumed along with the fall in US long yields.

The hedge-fund industry will play a central role in what happens next since it is often the market's marginal buyer (or seller); hedge funds now manage about US$1 trillion globally (double their 2000 level). Hedge funds as a whole were short on emerging

[7] See Fitzgerald (2005); Mody and Taylor (2002).

market debt in the first half of 2005, betting against high-yield debt in general on the expectation of weakness as the Fed Fund rate increases. Spreads over US treasuries rose, although not by as much as the spreads on US high-yield corporate debt. However, short positions are now being closed as the decline in long yields resumes making the carry trade profitable again. The risks are, however, rising all the time since with the compression in spreads between high-yield debt and treasuries, hedge funds must increase their leverage to achieve superior returns, increasing their chances of a blow up if spreads reverse their decline. One hedge-fund manager recently compared this to pushing down a spring 'you keep having to press it harder when it is already compressed and that is dangerous'.[8]

Long yields may rise independently of any action by the Federal Reserve if Asian central banks diversify significantly away from US treasuries, as many observers predict. However, for the moment the long-end is falling. For bears this is a temporary aberration indicating that the market has a misplaced belief that US growth will soften, thereby implying that the Federal Reserve will cease tightening after one or two more quarter-point rises. If the bears are right then US long yields will jump once the market realizes that it has underestimated the scale of Fed tightening; this will deliver a shock to emerging market bonds which will see a sharp rise in their spread over treasuries. In contrast, bulls see the downward trend in long yields continuing, the result of financial globalization and, perhaps, a reduction in the 'home bias' of investors over the last 5 years (see my earlier discussion). US yields, while low, are still higher than those in Europe and Japan, and hence attractive to international investors. As US yields fall, the level of demand for emerging market debt will rise further. This would then provide an excellent environment for increasing investor interest in the sovereign bonds of less well-known countries, especially the smaller countries of sub-Saharan Africa. How the bear-bull debate resolves itself will be critical to the fortunes of existing and newer borrowers in emerging market bonds over the next 5 or so years.

Given the very good run of emerging market debt, bears have looked for signs of trouble among the major borrowers. Brazil and Mexico loom large in investors' minds since they account for the largest weightings in EMBI+ (22.9 per cent and 19.6 per cent, respectively). Some believe that President da Silva, whose ruling party is now embroiled in a corruption scandal, will turn fiscally reckless in the run up to the 2006 elections, but this has yet to affect the Brazilian debt market. Likewise, both Moody's and Standard & Poor's have upgraded Mexico's sovereign debt rating. In 2005, Turkey's debt was expected to sell-off upon a 'no' vote in the French and Dutch referendums on the EU constitution—an outcome that is believed by many to reduce Turkey's chances of accession (thereby damaging the convergence of its interest rates with those of the EU). But the market rallied instead. Indeed, emerging market bonds

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[8] Quoted in 'Splish Splash', *Wall Street Journal*, 7 June 2005.

may have stronger fundamentals than the high-yield corporate bonds of OECD countries. Mexico is the biggest BBB-rated credit in Lehman's investment-grade bond indices following the downgrade of General Motors and Ford to junk status in May 2005.[9] But it may simply be the case that country policies are less important as a market driver than global capital supply for, as Manuel Agosin (2005: 4) notes, countries with a very wide range of policy stances typically experience substantial capital inflows during periods of global capital surge.

## 5 Globalization in goods markets and capital flows

Despite some problems among the smaller borrowers (notably Bolivia in 2005) the emerging bond market class as whole looks robust in the near term. Nevertheless we can still find some grey clouds going forward if we look hard enough. A potentially serious threat for the whole asset class is what happens next in China. The 'China factor' is an important reason why the market for emerging market debt differs from that of ten years ago (and a factor that would have been inconceivable 20 years ago). And it has several interesting and inter-linked dimensions.

First, China's high growth has raised world commodity prices and therefore GDP growth in commodity-producers, with the resulting buoyancy in tax revenues improving fiscal balances and sovereign credit ratings. This makes bond ratings vulnerable to any commodity-price shock resulting from slower Chinese growth. Any slackening of Chinese demand could be offset by rising demand from continental Europe and Japan, both of which are showing signs of recovery, but that recovery is itself partly driven by their rising exports to China (especially so in the Japanese case) and both regions face a longer-term growth slowdown as their societies age (see our earlier discussion). US growth remains perilously dependent upon its over-extended consumer, who remains vulnerable to any rise in mortgage rates from their present low levels (itself partly a product of Chinese purchases of US debt which contributed to lowering long-term interest rates upon which most US mortgage-financing is based). It is not inconceivable that governments in commodity-producing countries might offset the negative fiscal effect of a world commodity-price fall through better tax mobilization, but progress in this area has been generally slow (Brazil and Mexico) or entirely absent (Venezuela). Better domestic revenue mobilization remains one of their most urgent challenges, not least to dampen the scale of their adjustment to any future China shock.

Second, China is central to the story of low global inflation underpinning low interest rates. Many in the financial markets believe that China's low-cost manufacturing caps

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[9] Recent progress under the Heavily Indebted Poor Countries (HIPC) Initiative in relieving a portion of the debts owed to official creditors is also important to changing international investor perceptions and increasing the possibilities for these countries to fund their development expenditures via the sale of sovereign debt in international markets (Addison et al. 2004).

inflation in goods markets (while India's role in outsourcing contains service-sector inflation). This belief, which is not without foundation, has reduced inflation expectations and long bond yields. But rich countries must continue absorbing Chinese exports for low-inflation expectations to be maintained. Any major restraint on China's ability to export will undermine the low inflation story, and will ratchet up bond yields, thereby slowing global growth overall—and cutting away one of the foundations of the present inflow of capital into emerging bond markets. And any slowdown in growth will have a knock-on effect on the growth of the financial services industry in developing countries as well. Similarly, an upward revaluation in the renminbi, which the US is pressing the Chinese to undertake, will increase the cost to US consumers of imported Chinese goods (this is one of the paradoxes of US-Chinese relations).

Although China's performance certainly looks spectacular, it is in fact yet to recover the share of world output that it had in the late nineteenth century, during the first wave of globalization; Crafts (2004) estimates that China accounted for 12.5 per cent of global manufacturing output in 1880, dropping to a low of 2.3 per cent in 1950, and rising back to 7 per cent in 2000. As China's per capita income rises, so domestic demand growth will increasingly drive economic growth, but export growth will remain the main engine for the next decade at least. Access to an open trading system is therefore in China's paramount interest, but a surge in its exports of clothing and textiles following the expiry of quotas with the end of the Multi-Fibre Agreement at the start of 2005 stirred up a protectionist hornet's nest in Brussels and Washington DC.

Notwithstanding these problems, we should not make too much of present difficulties. First, if the US and Europe go beyond modest protection against China into something much more substantial then they will undermine their own interests in a multilateral trading system. And second, the differences between China, the US and Europe reflect national interests within the ambit of a global market economy, and do not arise from a contest between fundamentally different economic systems—as they did thirty or forty years ago when the Cold War was at its height. In that sense the politics of inter-state relations which underlies economic relations today has a less calamitous downside than it did for most of the years after the Second World War.

Second, and perhaps a more lethal factor, China is one of Asia's big buyers of US treasuries, thereby reducing yields at the long end of the US curve and making the whole class of emerging market debt—which trades at a spread above treasuries—more attractive to buyers. Any large-scale reduction in China's purchases of treasuries would raise US long yields (unless offset by additional purchases by other Asian central banks) thereby reducing the relative attractiveness of high-yield debt in general, and emerging market debt in particular. A slowdown in Asia's purchases of US treasuries, including those by China, is inevitable in any case as the renminbi and Asia's other currencies appreciate against the dollar thereby reducing the region's very large current account surpluses (and requiring a commensurate reduction in the US current account deficit

which is an unsustainable 6 per cent of GDP). A critical factor for the markets is whether this adjustment is orderly or not. If the former, then US long yields will move steadily upwards—which is what the Fed wants since it believes that US growth is now robust after the 9/11 shock and slowdown. The spreads of emerging market bonds over treasuries will then rise, but hopefully not too much to cause serious financing problems for Latin America and other borrowers. A disorderly adjustment would consist of a rapid sell-off in the US treasuries market (accelerated by hedge funds who would quickly take up short positions), a sharp jump in emerging market bond yields, and—in a worst case scenario—a liquidity crunch, locking up high-yield debt markets in particular.

Since China's own sovereign debt is attractive to investors (the 'Virtanen' story with which I began the paper), trouble in credit markets would hit China as well—perhaps therefore accelerating any initial slowdown in its growth. For this reason at least, China (and more broadly Asia) has an interest in an orderly and gradual adjustment of the present imbalances with the United States (IMF 2005). It is therefore highly unlikely that China would conduct a large and rapid sale of US treasuries, as some observers have speculated, and this is not a credible threat in US-China bilateral trade negotiations. There are, however, political 'wild cards' that could cause disorderly adjustment by pushing China into deep recession, resulting in a sell-off in emerging market debt. These include: the re-emergence of a strong domestic pro-democracy movement and a violent counter-reaction by the ruling communist party; a further deterioration in relations with Taiwan (with war being the worst-case scenario), and a deterioration in bilateral relations, both economic and political, with Japan. Since it is often 'unexpected' political events that initiate major global economic shocks, the tensions in the global politics of China's rise should not be discounted in any assessment of future international financial risks.

## 6 Conclusions

So what do we conclude from all this? We might say that speculation about the future is largely pointless; all kinds of forecasts can be developed, most of which will never come to pass and it is often the unnoticed trends, or completely unexpected events, that prove to be decisive. Nevertheless, we can discern some broad contours of the future in present trends.

The first set of these are the consequences that arise from financing the costs of ageing societies, notably Europe and Japan. This has powerful effects on international financial markets, and is one reasonably certain trend given the size of the retirement savings involved. But predicting which financial markets will benefit the most is much more difficult. The story in which ageing societies invest in the equity and bond markets of youthful developing countries could constitute the big picture for the next twenty years. As capital flows to developing countries are affected much more by risk rather than

return (i.e. variance as opposed to mean) there is potentially a 'win-win' outcome for both North and South where Northern investors get lower risk, and the South gets cheaper capital. If these capital flows are forthcoming then they will prove favourable to the expansion of Southern markets for sovereign debt, equities, corporate debt and, eventually, municipal debt and property as asset classes for Northern (and Southern) investors. To work, however, this scenario requires that societies with young populations use the capital flow effectively to achieve higher growth, with this in turn translating itself into higher returns for foreign investors so that more capital is forthcoming. Foreign investors must also be sufficiently risk-taking to allocate a large enough share of their portfolio to the relevant asset categories to significantly benefit from any superior returns. This will entail considerable institution-building and innovation, including better corporate governance among Southern companies (to protect shareholder rights), improved macroeconomic management to reduce exchange-rate and credit risks and to cope with the real-economy effects of the capital inflow (thereby ensuring that it enhances rather damages economic development), and the increased use of derivative instruments to hedge some of the exchange-rate and political risk for international investors.

The second trend is the rapid growth now underway in the financial services industry, which on some predictions will account for 10 per cent of global GDP by 2020—with much of the growth coming in the larger emerging economies (Goldman Sachs 2003). Deeper and more sophisticated domestic financial markets will draw in capital flows (attracting direct investment by international banks in joint ventures to provide financial services) as well as sending capital outwards (by offering domestic residents mutual funds that invest in foreign assets, in particular). This opens up new possibilities for connecting local demand for capital to the international capital market, including packaging microfinance loans into financial instruments that can then be sold to international investors (perhaps with some hedging of the currency risk) thereby enabling microfinance institutions to expand by diversifying from their present dependence on NGO and foundation funding. In summary, there is much potential but realizing these gains will not be easy. Fundamentally, the countries that most need external capital flow are the smaller and poorer countries but they have underdeveloped and illiquid capital markets and are often little known to investors who may bypass them in favour of the bigger, better known, and deeper financial markets of Brazil, China, and India. The smaller countries need more assistance to overcome information asymmetries and high transactions costs so that they can tap more effectively into international capital markets.

The third of our future trends comes from the recent and rapid growth in demand for emerging market debt, and the resulting compression in spreads over developed-market debt. There is considerable uncertainty over what happens next. Is the present market-strength the result of ample global liquidity (with real interest rates at historically very low levels) with the danger that as the interest rate cycle turns, and liquidity contracts,

emerging markets will turn down as they did in the past? Or have fundamentals in emerging markets improved sufficiently to attract continuing inflows even as US monetary policy tightens with, perhaps, the search for yield by investors from ageing societies putting some kind of floor under the market?

The fourth contour in the next twenty years of international finance relates to one of the biggest questions of all: will globalization, and specifically trade liberalization, continue or will it slow, or even stall and reverse? This is critical since globalization in goods markets (a massive expansion of low-cost producers) has been central to the formation of low expectations for future inflation—and therefore to the story of low and declining bond yields, to the benefit of borrowers in developed and emerging economies alike. Here the story can take many different future paths, depending very much on your chosen scenario as to how the relationship between Europe, the USA, and Asia's rising economies, especially China, will work itself out.

To conclude: today we see a large volume of global savings moving through an increasingly integrated global capital market in search of investment opportunities, but finding low (and declining) returns. Asia continues to pour ever increasing amounts into low-yielding US treasuries, the counterpart to historically large US fiscal (and current-account) deficits. Yet running alongside this process are appeals for more official aid and debt relief for poorer and smaller countries, especially in SSA, which urgently need more external finance to meet their development and poverty-reduction goals. Twenty years from now, this may be seen as one of the starkest contrasts in the present system of international finance.

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