DEREGULATION AND RISKS IN FINANCIAL MARKETS*

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This article analyzes the main features of international financial markets growth from the second half of 1980. It is stated that the sharpening of financial deregulation has modified competence terms among intermediaries whereas national financial structures weaken and the States become uncapable to limit the consequences of financial crisis. Deflationary tendencies of international economy have been stopped in the financial domains through the establishment of a yielding "ground" on the side of government shares and through the increase in derivate markets.

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I. INTRODUCTION

The fast development of financial markets and the big capital movements among intermediaries that operate abroad with different currencies and instruments, have sustained the conceptualization of financial globalization in the economic literature of the last years. Its course during those years, as well as its most important features and the risk of another international financial crisis are analyzed in this article.

1. FINANCIAL MARKET EXPANSION.

Several stages of expansion and contraction during the last 25 years in the international financial markets can be distinguished since the breaking of Bretton Wood up to the present. After the debt crisis of 1982, since the second half of 1980, financial markets reinitiated an acceletared growth that lasted until 1990. Another contraction of bank loans followed in 1991 that is partially conteracted by the continuous increase of security allocations in those markets.

There was a recovery of the international financial markets since the second half of the eighties based on new facts: the presence of new instruments and the sharpening of financial deregulation. In this new stage the fragility of exchange rates and the modification of rate interests led intermediaries and investors to search secure operations in the face of major risks. The conditions in which intermediaries operate before markets fragility pushed them to a greater competence and to risky business at the same time. Great interdependence of markets also opened risky frameworks and is conducting to bankruptcy and mergings among intermediaries as well as to banks crisis.

The derivates increase, less operations traded in dollars and the increased allocation of different currencies, the growth of bond and shares markets, the proliferation of off balance bank transactions from which there is little systematic and organized information, short limits between commercial and investment banks and governments operating as borrowers have characterized the expansion of financial markets during 1990.

During the sixties and the seventies there was an increase of international markets through commercial banks. Interbanking deposits have been as much a fundamental element for international financial markets growth as loans and the issue of bonds and shares. These deposits represent between a third and a half of the flow of net bank loans. Their decrease during 1979 and 1980 precedes international credits contraction in 1982. Interbanking deposits recuperate between 1985 and 1989 and their decrease in 1990 stimulate the decline of bank's loans in 1991. In the following years, the international financing recovery was due mainly to the issue of international bonds and shares. These were an important element of international financing in the second half of the eighties and continued to grow in spite of the sharp contraction of international loans during 1991.

Another international financing recovery initiated in 1992 and 1993. During 1994 the increase of real interest rates in the United States, under lower growing conditions than stronger economies, ran into another decrease, specially in the bonds market with fixed interest rates. This element pushed the international financing increase into other money markets instruments as well as stocks markets and syndicated credits at the beginnig of 1995.

The imminence of another international financial crisis has been restrained due to Governmet interventions, such as central banks participation in money exchange markets and State cash flows to prevent a decrease in stock markets. But the extraordinary increase and penetration of derivates has probably been the strongest element to restrain crisis. Organized markets of derivates initiated a fast development during the last years of the eighties. It is estimated that by 1994 these banks accumulated underlyings of about 9 trillion dollars. An estimate of about 9 trillion dollars should be added to these off balance instrument operations. Its violent growth is the increasing support of worldwide stocks markets. More than 55% of the organized markets operations belong to the United States, 15% belong to Japan and 23% operate in Europe.

Most of organized markets operations concentrate in future interest rates (65%) and in option interest rates (30%). Options and futures interest rates upon stock markets index and upon foreign currencies represent a minor part of derivative-products organized markets. It is estimated that 73% of off balance markets is composed of interest rates swaps.

The great increase of banks off balance operations and other financial intermediaries prevent a complete statistic appraisal of national and international financial activities. As a result of new regulations of Basel Committee and as part of an administration strategy of assets and liabilities, banks and financial intermediaries have developed off balance operations. At the same time, with the diversity of instruments, borrowers and investors find a coverage in the face of fluctuations of interest rates and money exchange.

In spite of the high risks of realizing a substantial part of this market through off balance operations, and the incapacity of financial authorities to supervise them, regulation and supervision have been very limited. That is the reason why even it was possible to achieve certain release of financial tensions on a time of extraordinary increase of derivate operations (1991-1993), promoted by a relative decrease of interest rates, they have strained again in 1994, when interest rates present important changes in the short term. Now these tensions appear with enormous restrictions on the side of financial authorities and operators as there is not enough information about the political and institutional conditions to limit an international financial crisis.

In a recent study about derivate markets, Larry Promisel and his collaborators from de the Federal Reserve concluded that: "For the development of expert technics with respect to market instruments and mechanisms, central banks should have high priority to continue monitoring and analyzing the developments in the market as a whole. The changes in interbanking relations are not fully understood yet and cannot be clarified by a wide statistics coverage only. Continuos contact among market participants will also be important" (BIS)

Governments and public sector entities in general have increased as borrowers in international markets since the eighties. The public sector debt has notably increased mainly during the eighties and the nineties, while inflationary levels are decreasing. Public deficits were strongly financed in open markets. It can be stated that these borrowers constitute the basis of expansion. The public sector's debt in relation to gross national product, from 8% in 1974 grew to 30% reaching 50% at the beginning of 1990 in Germany and Japan respectively. Northamerica's public debt initiates its growth in 1982 reaching about 53% in 1993. It is estimated that by 1995 it will reach 5 trillion dollars.

2. DEFLATION AND FINANCIAL DEREGULATION.

Integrated administration of the banks balance followed as part of the fast increase of domestic and international banking activity during the seventies. This tendency reversed during the eighties due to the domination of deflationary tendencies in most economies (UNCTAD).

The interest rates increase by the end of the seventies stimulated a general banking movement to restrain credit and refinancing. During the expansion stage of financial markets several debtors in domestic and international markets became "ponzi" debtors (Minsky), so that the credit expansion restrain jeopardized liquidity of borrowers going from illiquidity to insolvency. Financial crisis precipitated in 1982 and Third World major debtors proved to be unable to pay commercial banks.

The "debt crisis" paralized the movement of a part of banking assets by imposing a staggering restructuration with an important credit volume. The imbalance of maturities and the remuneration of creditors balance increased quickly, so banks required of the formation of low cost liabilities and extended terms under low increase of assets. But, at the same time, they mantained part of their assets "frozen" with credits that under interests delay intended to promote under pressure the formation of preventive reserves (Harrington).

This situation provoked other effects, to the extent that banks had a part from their assets "frozen" in countries with overdue loans and insolvency, the other part of their assets showed flexibility in their management so that a tendency to use negotiable credits appeared. It was sought to improve the balance by increasing margins, with a slow balance growth so that pressure would not be exerted over their own funds and make commissions to increase. Therefore, banks continued operating with less balance growth, but specially diminishing maturity imbalances to the extent that they could obtain negotiable assets without renovation conditions, thus mantaining maximun flexibility in their assets.

With securitization, that the same banking system imposed, limits between commercial banks and investment banks tend to disappear. They have been created due to the balance administation adaptations, of assets and liabilities, and to the new conditions that markets with high levels of debt and low levels of investment and growth have been set upon them.

The active administration of banks balance and credit securitation during the eighties modified the organization among intermediaries and the diversification of financial enterprises and its association. The multiplication of instruments and operations accelerated changes in the financial world during the eighties. Through securities, banks reached a reconfiguration of their assets and changed competitive terms.

Bank crisis that followed during the eighties, United States credit-crunch at the end of those years, due to the excesive leverage of enterprises, and the adjusting of the banking system to the norms of the Basle Committee about capitalization, are among the facts that prompted the explosive growth of derivate markets. Besides, its expasion goes hand by hand with the main stocks markets growth in the world. Other elements that seek to explain the fast increase of derivate markets are the technological development of the sector, markets volatility, the prevailing of financial no-bank intermediaries, and deregulation, or rather the excesive markets regulation (Witschi and Holzer).

Even if it can be said that derivates in themselves do not increase the mass of available financial resources, it is also true that intermediaries participate in its positioning and exchange, thus increasing financial assets in the exchange. Financial intermediaries use derivate instruments either as a means to administer its risks or to increase incomes (Sinkey, Hiles and Carter).

The Bank of International Settlement considers that the expansion of derivate markets is due to the volatility of markets: "They have all been developed for the purpose of managing the risks associated with changes in asset prices, and the increase of volatility of interest rates, exchange rates and share indices in recent years is the factor which has contributed most to their success. But the scale and scope reached by these markets, particularly those instruments with option like features, would not have been possible without the changes in information and trading technology which have taken place since the beginning of the 1980s."(BIS)

The use of derivate instruments has also increased significantly because besides providing liquidity, before the increasing uncertainty of markets, derivate financial customers claim for coverage instruments. "Here, the primary economic function of exchange trading derivates seems to be to provide liquidity, which is the ability to alter exposure to market movements cheaply and quickly...as growing securities trading volumes increased the apetite for risk hedging instruments." (Witschi and Holzer)

The wide difussion of derivates has transformed the payment system in most economies. Derivates have worked as an important extension of the payment system to the extent that they substitute a great variety of ways to use cash. (Perold) This modification of the payment system which was provoked by the expansion of derivate markets has been very important to moderate deflationary tendencies in economics, particularly in the financial markets.

To illustrate the importance of the trade volume and the deep modification in liquidity volumes that the expansion of derivate and the financial innovations as a whole provoked, it can be mentioned that the funds volume that flow through the northamerican payment system represent between 1.5 and 5 times gross national product between 1854 and 1965 to more than 70 times of such product in 1993. "The magnitude of the increase of payment volume seems entirely confered to a structural change: to diminish trading and costs risks in the face of technological and financial innovations...it takes only three days nowdays to make funds transferences through the northamerican payment system to equal the annual gross national product." (Perold)

Thus, the deep modification in the payment system even if it has contributed to prevent deflationary economic tendencies, it has also been an important feature for the fragilization process of financial markets and in the formation of suitable conditions to provoke a financial crisis upon which a very low capacity to control on the side of financial authorities would exist.

Particularly in the United States, the new financial instruments have quickly penetrated in the whole market's structure with a very low or nule capacity of the northamerican government to respond to a financial crisis coming from derivate markets. Competence among the different derivate instrument markets has increased during these years. In derivate markets, big banks and stock exchange markets of the United States, Japan, France, Great Britain, Germany and Switzerland are the dominant ones, and the small and medium ones tend to be the final customers. (Sinkey, Hiles and Carter)

In the case of the United States banks, by the end of 1993, 670 banks used derivates, either as final customers or positioners, in contrast 10 000 banks did not use them. There is a big concentration in the customers group, 15 members of the International Swaps and Derivatives Association amounted 93.6% of the activity in derivates from commercial banks. Out of 15, 6 of them (Banker Trust, Bank of America, Chase, Chemical, Citicorp and Morgan) are described as "ruling world derivatives" for they ammount 89.5% of derivatives owned by the 15. (Sinkey, Hiles and Carter)

Derivate product markets in the world are basically controled by a few intermediaries. There is "...a high concentration of derivative activities. Today, not more than fifty institutions worldwide dominate the business with the bulk of the activity accounted for by a much smaller number." (Witschi and Holzer).

The main part of swaps on interest rates are managed by big banks, by the end of 1992, the twenty biggest world dealers accounted for conditions in swaps of 4.2 trillion dollars. From the underlying value, six of these ones were american banks. Concerning american banks, between 1985 and 1993 the underlying value of interest rates swaps represented 6.9% and 80% of total assets, 111.2% and 1 003% of shares capital respectively. More than 50% of these instruments have maturities of less than a year and replacement values in 1993 reached 76 billion dollars. This gives an idea of the level of loss involved in case of failure and therefore of rescue costs. (Gordon and Rosen)

The growing risk in derivate markets has been of great concern among different analists and financial authorities. They are particularly concerned by the insufficient information that financial and regulatory authorities have, therefore their performance in case of crisis would be very limited.

Even if the rol of derivate instruments is to distribute or to share risks, "from a systemic point of view this should be of fundamentally stabilizing and not destabilizing nature. However, the explosive growth of the derivate market may have created new risks with systemic implications. Systemic risk is ultimately a kind of cumulative credit risk (counterparty risk). Credit risk may be triggered by inexpectedly sharp movements in it underlying asset in one direction...by mismanagement at the operational level...and strategic level." (Witschi and Holzer)

Policies concerning regulation and supervision have been drawn towards recommending the improvement of information systems and transparence of over-the-counter operations, as well as the improvement of payment systems and the introduction of capital requirements to intermediaries. These expeditions to improve the supervision have not been fully agreed upon yet by the different countries, and they have not been instrumented in the markets either. Six of the main Wall Street financial intermediaries voluntarily agreed, after succesive discussions during 1994, upon reinforcing their control over their sales and derivate trading in cooperation with SEC in march 1995. Industries agreed to make regular reports about their private derivates trade. This self-proposal of normative supervision emerges from the first time after the emphasis these intermediaries have received by loss related to derivates from industries like Procter and Gamble, municipal governments like the County of Orange and Mutual Funds. Even when most of the problems come from listed derivates and not from off stock exchange.

Limits that exhibit the new regulatory tendencies emphazising self-regulation with supervision upon financial intermediaries are visible, even for the same regulatory authorities. Among them are the problems to extend capitalization norms to stock exchange intermediaries, risks control in the concentration of assets in certain activities, industries or countries, and problems in the supervision of conglomerated financial entities. All of these problems have been discussed about in different meetings of the Basle Committee and which are still considered of long term resolution, particularly because of the very different regulatory frameworks and forms of organization in the financial systems of major economies.

The recent bankrupcy of Baring (1995) involved operations in derivate instruments, exhibited again regulation problems as well as financial supervision problems and also exhibited the limited performance of financial authorities when they put into scope markets problems from the supervising point of view, pretending that with quality supervision deregulation can take place without menace of bank or financial crisis. Another obstacle for the development of supervising is the laundry money coming from drugs traffic with particular repercussion over derivates markets. (Davis)

Deregulation during 1980s and 1990s, when the deflationay process starts, emphasizes risk coverage, financial risks and bankrupcy that is directly and imminently percibed. It also emphazises the multiplication of guaranties and the same financial innovation, as well as government coverage or the transference of losses to public budgets, through the modification of accounting and fiscal norms or through rescueing.

There is a growing concern among financial authorities of major economies about financial inestability, about the multiplication of bankrupcies and about a growing unability to forsee and to stop the development of bankrupcies. There are growing difficulties for the performance "as a last lender resort", such as the Sanders Amendment in the Congress, as well as a fear for the development of a financial crisis that provokes a wide decrease of all financial assets, and the incapacity of local supervising organizations, including IMF, to warn about insolvency or illiquidity of intermediaries and countries.

The Halifax meeting of the seven most developed countries in june 1995, was again a major concern, the Secretary of the Treasury Robert Rubin pointed out the impossibility of the United States to continue acting as a last lender resort. OCDE in its semestral report blames for the lack of discipline of markets and proposes regulations towards clearing up and improving markets information. None of the countries eliminates the possibility of other financial crisis or the fact that international financial institutions do not posses the necessary elements to stop it.

Deflationary tendencies of international economy have been stopped in the financial domains through the establishment of a yielding "ground" on the side of government shares and through the increase of public debt in national states, particularly in developed countries. Also through the diversification of portfolios though the movement of non-financial assets in underdeveloped countries and the leverage of fussion and purchasing processes among enterprises as well as the multiplication of risk coverage instruments, interest rates and rate of exchange.

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