The increasing clout of the global capital market is said to be eroding governments' ability to steer their economies. That may be no bad thing if it prevents them from acting unwisely, argues Pam Woodall, our economics editor.

Over the years, democratic governments have fought many enemies, from fascists and communists to monopolists and over-powerful trade unionists. One way or another, they have defeated them all. But now a more insidious enemy has appeared on the scene who, many claim, has already accumulated far too much power while no one was looking: the electronic army of currency and bond traders. As the world economy seems to lurch from one financial crisis to another, the blame is being put on financial markets. National economic sovereignty, say the critics, is being eroded by massive international capital flows, leaving governments powerless to defend their countries' economic interests.

Recent bouts of financial turmoil are being quoted in evidence. The ERM crises in 1992 and 1993 witnessed the humiliation of governments and central banks by currency speculators such as George Soros. Likewise, the bond-market crash in industrial countries in 1994, Mexico's recent debacle, and the plunge in the dollar to record lows earlier this year all demonstrated how cruelly global financial markets can punish countries whose policies they judge inadequate.

James Carville, one of President Clinton's election advisers, sums up many people's view of the bond market: "I used to think that if there was reincarnation, I wanted to come back as the president or the pope. But now I want to be the bond market: you can intimidate everybody." European politicians tend to be more contemptuous of markets. Jacques Chirac, France's prime minister, recently described speculators as the "AIDS of the world economy". Perhaps most telling of all is the--possibly apocryphal--graffiti seen on a wall in Poland: "We wanted democracy, but we ended up with the bond market."

The past two decades have seen a revolution as domestic financial markets have been opened up to create a massive global capital market, beyond any government's control. The behaviour of this vast pool of capital can make all the difference between success or failure of an economic policy. This means, claim the alarmists, that such policy is being set not by democratically elected governments but by irrational and selfish currency speculators and bond-market vigilantes, interested only in making vast piles of money. It is argued that fierce financial markets, divorced from economic fundamentals and indifferent to broader social concerns, determine who has a job and how much a mortgage will cost. Such fears have prompted demands that governments curb the markets' power.

This survey will look beyond the hyperbole at the real relationship between financial markets and policy-makers to determine just who controls the world economy today, and whether it makes sense for governments to try to restrain those financial markets.

The economic arms race

Twenty-five years ago governments had impressive-looking policy toolkits with which to steer their economies, replete with taxes, public spending, interest rates, credit controls, exchange rates, capital controls and incomes policies. Yet those toolkits have been plundered by the deregulation of domestic financial markets, the liberalisation of international capital flows, the arrival of powerful computers and telecommunications, and rapid financial innovation. All these changes have delivered explosive growth and enormous power to the financial markets. Since 1980, the total stock of financial assets has increased two-and-a-half times faster than the GDP of rich industrial economies, and the volume of trading in currencies, bonds and equities faster still (see chart 1). And as global capital markets continue to expand, so will their power.

Financial liberalisation has delivered huge benefits. A free capital market ensures that savings are directed to the most productive investments without regard for national boundaries. Capital can flow from capital-rich developed countries to opportunity-rich emerging economies. Increased competition has created a more efficient financial system, offering better opportunities for savers as well as lower costs for borrowers. Fancy new instruments such as derivatives (futures, swaps and options) help firms to manage financial risk more effectively. The long-run result should be higher investment and growth.

But there is no free lunch. The price governments have to pay in this instance is a weakening of their traditional economic armoury, both in terms of the policy choices available and of the effectiveness of the weapons they can use. In particular, the shift of power from policy-makers to financial markets has triggered four popular worries:

First, it is argued, the foreign-exchange and bond markets' sheer muscle can overwhelm monetary and fiscal policy, leaving governments powerless to influence interest rates and exchange rates. Financial markets have become judge and jury of economic policy-making. If, for example, the markets do not like a cut in interest rates, they will counteract it by driving up long-term bond yields.

Second, central banks and governments are accused of trying too hard to please financial markets instead of pursuing long-term social and economic objectives that will benefit their countries. Doomsters fret that by accommodating inflation-obsessed bond vigilantes, monetary policy-makers will impose excessive deflation on economies.

Third, global financial liberalisation and the vast array of new financial instruments are said to have blunted the effectiveness of monetary and fiscal tools, so that changes in interest rates or government borrowing have a smaller impact on the economy. Examples put forward include the expansion of electronic cash, which may cause central banks to lose control of the money supply, and the growing use of derivatives, which allows firms to insulate...
themselves from changes in interest rates.

Fourth, liberalisation and innovation have made financial markets much more volatile as well as much more vulnerable to financial meltdown, with worrying implications for economic stability.

Three cheers for the market

Have financial markets become too powerful? Each episode of financial turbulence brings forth more demands for governments to subdue markets by methods such as closer international policy co-ordination and the imposition of capital controls or transactions taxes. This survey, in contrast, will argue that in general there is little cause for concern about the constraints that financial markets impose on government policy. On closer examination, it becomes clear not only that governments have managed to hold on to quite a lot of their power, but that the effect of losing some of it has been beneficial all round: the markets provide a healthy discipline which in the long term will encourage better economic policies and performance. If the global capital markets punish profligate governments by demanding higher interest rates, those governments may become more inclined to pursue sound policies.

Richard O'Brien, an economist at Global Business Network, an international consulting group, points out that the power of governments over their economies has traditionally been based on the ability to tax, the ability to print money and the ability to borrow. A liberalised and globalised capital market limits the abuse of all three powers. If a government tries to tax business too heavily, firms will simply shift their production elsewhere. Likewise, if a government borrows recklessly or allows inflation to creep up, investors will seek refuge in another currency. For workers, companies and savers, a government's loss of such powers is reason for cheer, not fear: all that is being lost is the power to pursue damaging policies, and practice economic deception by letting inflation rip.

Indeed, as global financial markets become more integrated, acting as a single market in pricing risk, the reward for pursuing the right policies will become bigger. Sound economic policies will earn more generous returns while policy blunders will be punished more severely. In that sense, governments will actually have a larger role to play.

But are financial markets suitably qualified as economic judges? The degree to which liberalised financial markets encourage better macroeconomic policies depends on how well such markets work. Foreign-exchange and bond markets are popularly portrayed as irrational casinos engaged in an orgy of speculation. People talk about "The Market" as if it were a sinister conspiracy of wealthy individuals controlled by a single brain, quite unconnected to the real economy. In 1992 some governments convinced themselves that that evil brain belonged to George Soros, whose Quantum fund made $1 billion on Black Wednesday by helping to push sterling out of the ERM.

In fact, financial markets reflect the perceptions of risk and reward of millions of individual investors, from pension funds, banks, hedge funds and wealthy individuals to businessmen wanting to raise money, home-buyers, and pensioners looking for ways to invest their nest-eggs. The global capital market is simply a mechanism for pricing capital and allocating it to its most productive uses. Markets are in the business of gathering and processing information. To a large extent, they simply hold up a mirror to the economy. Breaking the mirror will not change the picture it reflects. If the markets expect higher inflation, then they can anticipate it by pushing up bond yields now, in the hope of saving trouble later.

Most of the big swings in asset prices, such as the fall of the dollar or the Mexican peso crisis, can be traced back to economic imbalances and policy errors. That does not mean, however, that the market is always right. It may move rationally in the long term, but the strength and timing of market reactions can seem out of line. Financial markets exercise discipline erratically: they can be slow to punish the guilty but then correct themselves abruptly, with painful consequences. At times they may even give perverse signals which encourage governments to pursue more, not less, profligate policies.

In this increasingly uncertain environment, one thing is sure: plenty more clashes between global markets and national governments lie ahead. The danger is that some governments will be tempted to respond to market excesses by trying to force the global capital market back into a straitjacket. But they would be bound to fail. Governments would do better to rethink the way they conduct policy to avoid destabilising market expectations, and ensure that markets are better informed so they can become stricter disciplinarians.

The challenge is to help the global capital market to become more effective in encouraging good behaviour. To increasingly frustrated politicians, it will appear that governments have been defeated. Their scope for promising voters heaven (and delivering hell) is shrinking. But in the long term, the real victors are not just the financial markets but also companies, workers, savers and pensioners.