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.