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The Perils of Financial Globalization
A South View**

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I- Introduction:

The literature on globalization has rapidly mushroomed over the past 10 years. Public fora concerned with the issue span the whole spectrum between the World Economic Forum in Davos and the World Social Forum in Porto Allegro. Anti-globalization movements are to be found almost everywhere around the globe- both North and South.¹

This indicates clearly that globalization has come to be a very controversial category- with many who are solidly for it, and those who strongly, sometimes even violently, oppose it. We are not concerned here with public (popular) action related to globalization. Our interest is rather in the globalization discourse: making a contribution to the debate by emphasizing some aspects of the view of the South on the issue- with special emphasis on financial globalization and its implications for financial crises.

We shall argue that the increased use of derivatives, particularly through over the counter trading and off-shore financial centres by large and complex financial institutions over the last two decades, represents a radical change in the international financial system. Such a systemic change may increase the likelihood of the outbreak of financial crises. Financial crises may not only result from bad policies by afflicted countries, but may also be the product of systemic dysfunction. In this context, the call for the the outright and

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wholesale liberalization of the capital account of developing countries is unwarranted. From a developmental perspective, liberalizing FDI flows may be beneficial, while liberalizing FDI may be harmful.

The paper is organized as follows. In **section II** we deal with the definition of globalization. There, one actually swims a vast sea. We shall focus on the main alternative definitions in an attempt to come up with that which serves better the purpose of this paper. Financial globalization (related to the nature and scale of cross-border capital movements) is one of the most critical elements of globalization. Because of the recurrence of devastating financial crises, apparently with increased frequency, financial liberalization has become a very controversial issue. This is all the more so in connection with the causes and consequences of financial crises and what to do about them. **Section III** deals with financial globalization as a critical aspect of globalization. In **section IV** we draw the implications of financial globalization for financial crises. Here we address the relative validity of bad policies vs. systemic dysfunction approaches to explaining crises. We expound the view of the South with regard to financial liberalization in **Section V**: what is the south view on financial liberalization, and how does the South view financial crises? We conclude the paper with closing remarks in **section VI**.

II- Globalization Defined:

At the risk of offering a simple characterization of a complex and multi-faceted phenomenon, globalization may be viewed as a process which partly involves redefining time and space. As such, globalization is simultaneously an old and a new phenomenon. If we confine it to the volume of international trade, it is old since for the industrial countries the level of merchandise trade relative to GDP reached in 1913 was not attained until the late 1960's or early 1970's. Some countries have not reached the earlier level yet, such as Australia, Denmark, Japan and the United Kingdom (Feenstra, 1998). But it is a recent phenomenon if we broaden it to include such aspects as financial flows, trade in services, outsourcing of production, etc. These have become

particularly important in the light of the outcome of the Uruguay Round of the General Agreement on Tariffs and Trade (also known as GATT 1994), whose implementation started with the establishment of the World Trade Organization (WTO) in 1995.

Our interest in this study is in the new vintage of globalization, embodied in GATT 1994 and implemented by the WTO through the enforcement of its rules and regulations. Since there is no universal definition of globalization, the literature will be reviewed to select the appropriate and operational concept to be adopted for our analysis.

For some authors, globalization is perceived as an abstract concept that does not refer to a concrete object but to an interpretation of a societal process (Lubbers, 1998). Others define it as the process by which nationality becomes increasingly irrelevant. According to this perception, one may think of two strands of globalization. There is globalization of consumption, referring to the situation where the nationality of the consumer becomes independent of the nation in which a product was made. And there is globalization of production/ownership, indicating that the nationality of the owner and controller of productive assets is independent of the nation hosting them (Head, 1997).

Michel Camdessus, the former managing director of the International Monetary Fund (IMF), described globalization as an architecture made up of seven building blocks that will, in his view, lead to the prosperity of the world. The seven blocks are: The tremendous potential for growth and prosperity globalization provides countries fully integrating into the global economy; integration (by integrating themselves, the poorest countries will accelerate development); the universal consensus on the importance of an increasingly open and liberal system of capital flows; the golden rule of transparency; good governance; a set of standards and codes of best practices; and the option for the multilateral approach to handle problems that are now more global in nature (Camdessus, 1998).

Hirst and Thompson prefer to differentiate between globalization and internationalization. In the international economy, trade and financial flows take place

between nations and under the regulations and laws of those nations. On the other hand, in the global economy all the international relations (trade, capital flows, etc.) take place under unified international laws and regulations issued and enforced by international institutions. According to them, the world at present is undergoing an “internationalization” phenomenon and not a “globalization” phenomenon. The difference between “international” economy and “global” economy is based on the units (or entities) which the world is composed of. (Hirst & Thompson, 1996). It should be noted, however, that the trade flows are increasingly being governed by the international law of the WTO, and capital flows are regulated by the international “soft” law (Eatwell and Taylor, 2000).

Stiglitz, identifies the essence of globalization as the closer integration of the countries and peoples the world over brought about by significant cost reduction of transportation and communication and the reduction of artificial barriers to the flows of goods, services, capital, knowledge, and (to a lesser extent) people across borders. According to him, globalization is driven by multinational corporations, and governed by the IMF, the World Bank, and the WTO (Stiglitz, 2003). On the basis of the above, perhaps the most operational definition of globalization for our purpose is the one which characterizes globalization in terms of its major dimensions. Globalization is a process which involves trade liberalization, financial liberalization, outsourcing of production, and the increased harmonization of economic institutions and regulatory framework in the countries of the globe (Cardoso, 1996; Korayem, 1998; Sachs, 1998).

To study the implications of globalization for financial crises, we should first acquaint ourselves with the current state of globalization in the area of finance. This will clarify the present picture of financial globalization which will enable us to examine its implications for the likelihood, frequency and scope of crises.

Financial liberalization is one of the most important aspects of globalization. Liberalization involves both short-term capital flows and foreign direct investment (FDI).

The former is the most important component of the financial liberalization because of its implications for financial crises. Liberalization of short-term capital flows minimizes risks and maximizes profits for the investors in the financial markets. International financial markets allow residents of different countries to pool various risks, achieving more effective insurance than domestic markets would allow. On the other hand, despite the positive impact of financial liberalization on that score, liberalization of short-term capital flows has its negative impact on investment and production., the quick and large profits that short-term capital may bring in a relatively short period of time by moving globally between financial markets reduces the supply of funds available for direct investment. It has been observed that the increase in profits achieved by the globalization of production does not translate into increased investment in production as might be expected. Instead of being ploughed back into production, a good part of these profits finds its way to financial markets abroad (Obstfeld, 1998).

On the basis of the above, and at the risk of offering a simple characterization of a complex phenomenon, globalization may be viewed as a process which partly involves redefining time and space (Abdel-Khalek, 2000). Thanks to advances in information and communication, the time dimension as a barrier in the face of responding to certain market signals is shrinking at an accelerating pace. Also, space as a barrier that can separate individual actors, for example residents and nonresidents, is steadily shrinking. In this context, the domain of sovereign entities (e.g. governments) is being actually curtailed. In a globalized world, national governments may continue to rule, but they cannot always govern or control.

III- Financial Globalization:

As we already demonstrate clearly below, integration of financial markets has increased tremendously since the early 1970s. Several factors have contributed to financial market integration. These include the collapse of the Bretton Woods system of fixed exchange rates (the gold exchange standard), the liberalization of domestic capital markets,

liberalization of international capital flows, and the very rapid development of information and communication technology. But while the development of information and communication technology may be universally hailed as a natural and positive development, the liberalization of capital flows is neither natural nor absolutely positive. It is a manifestation of a specific policy stance which reflects the predominance of the Washington consensus of neo-liberal economic preaching. It does not have a solid theoretical foundation; it is largely the ideology of the market cult as promoted by the International Monetary Fund, the World Bank and the US Treasury Department. The growing integration of financial markets has clear and important implications for the conduct and effectiveness of macroeconomic policies and for systemic risks.

Since markets get integrated in a number of ways, the extent of globalization of financial markets may be gauged by a number of indicators. (Fischer and Reisen, 1993). Although one obvious indicator is the scale of capital flows between countries, there can be a high degree of integration even without a large volume of cross-border capital flows (IMF, 1991). This suggests that additional measures besides the scale of cross-border capital flows should be used for gauging the degree of integration of financial markets.²

(a) One such indicator is the phenomenal increase in cross-border finance of different types. Particularly over the past three decades, both gross and net flows of capital across national borders have increased markedly. But the growth of FPI flows has been significantly much faster compared to FDI flows. Consider the data reported in Table (1). For the major industrial countries as an example, gross flows of FDI increased from US\$ 14.45 billion in 1970 to US\$ 448.32 billion in 1997 (i.e. 32 times). On the other hand, gross flows of FPI skyrocketed by close to 200 times over the same period (from US\$ 5.26 billion to US\$ 1040.19 billion).³ It is also interesting to note from Table (1) that gross FPI flows were several times net flows (reaching as high as nine fold in 1985). This depicts the usually short-term nature of FPI flows which may move in and out of the country more than once in the course of one single year. The contrast between the behavior of FDI and FPI is clearly demonstrated in Figure (1).

(b) Cross-border securities transactions offer another gauge of capital market integration. Again, take the case of the G7 countries. For this group of major industrial countries taken together (excluding Britain), while cross-border transactions in bonds and securities averaged only 5% of GDP in 1975, they reached three-and-half times GDP in 1997 (IMF, 1998, Table A5.9). As shown in Table (2), if we exclude Japan as an outlier, the jump is from 4% to four-and-half times GDP during the same period. Figure (2) illustrates this trend very clearly. It is remarkable that in the case of the US, Canada and France, the increase in cross-border transactions in securities has greatly outpaced economic growth

(c) Financial globalization is also illustrated by the fact that trading in the global foreign exchange market has far outpaced the growth in international trade in goods and services. Here, no time-series data are available on an annual basis. Let us consider the evidence for 1995. While world exports of goods and services amounted to the equivalent of US\$ 6.1 trillion, daily foreign exchange market transactions reached US\$ 1.2 trillion. On a comparable basis, annual foreign exchange market turnover is almost 50 times the value of international trade in goods and services. This is a very telling indicator of the globalization in financial markets, which reflects the fact that foreign exchange is increasingly being treated as an asset or a commodity, not just as a means of payments. It is also a reflection of tremendous increase in the use of derivatives in foreign exchange markets. If we add to foreign exchange transactions the transactions in securities (bonds and equities) and financing, international trade in goods and services really pale in relative magnitude.

(d) One may also note the increased correlation between changes in NASDAQ⁴ index and the equity prices in emerging markets. Table (3) shows that the correlation coefficient between changes in the emerging markets' equity prices and the NASDAQ index has increased significantly since the mid-1990s: quadrupling in the case of Malaysia and almost quintupling in the case of Taiwan between 1995-96 and 1999-2000. Carreiri et al. (2002) report estimates of integration indices for eight emerging market economies (Argentina, Brazil, Chile, India, Korea, Mexico, Taiwan, and Thailand)

which also suggest an increasing degree of integration of these countries during the last decade.⁵

But how and in which ways are financial markets becoming integrated? There are several ways through which financial integration occurs- most importantly (IMF, 1998):

- (i) exchanges promoting participation in their local markets by relaxing membership criteria to bring in offsite members;
- (ii) the switch from floor trading to screen-based trading or marrying the two opens the door to remote membership;
- (iii) the financial information business (which is dominated by the big four: Reuters Holdings, Bloomberg, Dow Jones Markets, and Bridge);
- (iv) exchanges linking up across national borders, motivated by economies of scale to cut average cost of doing business;⁶ and
- (v) the Internet.

Globalization of finance has mainly occurred through over-the-counter (OTC) markets⁷, where trading takes place by means of such communications technologies as telephone, fax, and telex. OTC trading has by far outstripped the exchange-traded markets; Trading is thus untied to a specific geographical location. Notional principal amounts of outstanding exchange-traded derivatives at end-December 2000 was about US\$ 14.3 trillion, compared to close to US\$ 95.2 trillion for global over-the-counter derivatives. (IMF, 2001: 22-24). At end-December 2002 the figures were US\$ 23.9 trillion and US\$ 141.7 trillion, respectively. (Table 4).

In the post-Bretton Woods world, there is a high degree of risk and uncertainty regarding foreign-exchange rates and interest rates. financial innovation creates markets and products for risk unbundling, pricing, trading and management. Since risk is an externality, the essence of financial derivatives instruments is the internalization of risk. There are many types of risk: market risk, credit risk, liquidity risk, operational risk, and

settlement risk.⁸ They are closely interrelated; for example, there is a strong correlation between market risk and credit risk.

The structural changes that have occurred in national and international financial markets, particularly during the past two decades, can be seen as part of a complex process best described as the globalization of finance and financial risk. Several key elements of this on-going process warrant attention. First, is the mushrooming of offshore financial institutions and their increasing capacity to create liquidity (money), without being accountable to any regulatory agency⁹ (Buckley, 1996; IMF, 2001). Second, the phenomenal growth of financial derivatives. This has strengthened the technical capabilities for engaging in so-called precision finance, viz. unbundling, repackaging, pricing and redistributing financial risks (IMF, 1998). Third, is the growth of OTC transactions (IMF, 2001). Fourth, the increasing concentration in major financial centers as manifested by the emergence of the global bank and the international financial conglomerate, each offering a mix of products and services in a wide range of markets and countries. So-called large and complex financial institutions (LCFIs) pose clear systemic and policy challenges (Johnston *et al.*, 2003).

One important implication of this is the existence of unequal powers in the market place. For example, Fidelity, America's largest institutional investor manages \$900 billion worth of assets, which is equivalent to about half the combined total stock market capitalization of the South! Another example is the Long-Term Capital Management (LTCM), which was reported by the *New York Times* to have controlled a US\$ 125 billion position in securities and that derivatives raised its overall exposure to US\$1.25 trillion (as referred to in Mehrling, 2001:153). Fifth, and perhaps also related to the previous development, is the increased desegmentation: the traditional distinction between banks and non-bank financial institutions is increasingly blurred. At one end, traditional banking institutions have been transformed into new financial services firms taking on new lines of business and new risks -including those of asset managers, insurance companies, and institutional securities' firms. At the other end, non-bank financial institutions such as insurance companies, mutual funds, and pension funds now

actively engage in operations which used to be the traditional domain of banks. All this transformation seems to have been propelled by the liberalization of capital inflows.

The Mexican crisis of 1994-95 (with the ensuing Tequila effect) and the Asian crisis of 1997-98 have raised deep concern as to the effects of financial globalization and the management of risks associated with the surge of capital inflows followed by a halt, or even a reversal, of such flows- particularly portfolio and other private capital flows. Thus, net flows of portfolio investment into emerging markets of the Western Hemisphere plummeted from US\$ 60.6 billion in 1994 to US\$ -0.1 billion in 1995. For the Asian emerging markets, net inflows of portfolio investment sustained a staggering 164.2% drop in 1997 (IMF, 1998, Table 2.1). In terms of potential effects, massive and sudden movement of capital may be more similar to a locust swarm than to a swarm of bees.

There are of course several implications of the structural changes just noted above. We focus here on implications for financial crises. As a result of loosening capital controls and financial deregulation, capital has become almost completely free to roam about. Thanks to the high degree of leverage of such financial derivatives as futures, options, and swaps¹⁰ (because of significantly low margin requirements)¹¹ it is possible to control large amounts of capital. Derivatives also involve high exposure- witness the case of LTCM already mentioned. This may be illustrated by the gross leverage indicator for the top 25 US commercial banks. Although values of the indicator over the period 1996-2000 exhibited strong fluctuations, it was always significantly above total on-balance-sheet leverage. In the build-up period during emerging markets boom (1998), gross leverage rose from 80 to close to 98 (IMF, 2001: 24).¹²

Through unbundling, redistributing and managing risk, derivatives have greatly facilitated the growth and expansion of capital flows. At the same time, they increase market price volatility significantly.¹³ In addition, they may be used in such unproductive activities as evading taxes, avoiding capital requirements, and manipulating accounting rules (Dodd, 2002). With the high leverage inherent in derivatives, they can potentially

create systemic dangers and risks. This point is largely neglected in the literature on financial crises, and thus deserves more emphasis here. Derivatives instruments allow firms to assume a given position by committing less capital compared to an equivalent position through the cash market. Since derivatives are generally traded on margin (an example of gearing or leverage), gearing allows market players to make larger trades than they could otherwise afford. Firms thus find it cheaper to acquire leverage through derivatives than through on-balance-sheet transactions. Forward contracts are the least costly way of acquiring exposure among all types of derivatives instruments, since they require no margin payment or posting of collateral (Reuters, 1998). At the other end, options are the most costly derivatives instrument for acquiring leverage, since in most exchanges buyers have to settle their purchase and pay the premium for their contract.¹⁴ Futures contracts fall in-between, as they usually trade at a 5-10% margin on a mark-to-market basis- which involves both an initial margin and a maintenance margin.¹⁵

Using leverage, many hedge funds and other institutional investors design strategies to bet on expected developments in various asset and commodity markets by committing only the bare minimum of their own equity. The problem is compounded by the practice of putting derivatives positions off the balance sheet. Breuer presents a scenario which illustrates the way in which an institution can lever up its equity through the use of a combination of on-balance-sheet and off-balance-sheet transactions. This scenario is actually inspired by the case of LTCM (Breuer, 2000). But it is hypothetical, yet not totally unrealistic; it is typical of the leveraged positions taken by many hedge funds and investment banks. According to Breuer, this leverage scenario involves five layers. (i) Engaging in interest arbitrage to take advantage of Japan-US interest rate differentials by using a small part of equity as collateral for a yen-denominated loan which is then exchanged for US dollars and used as collateral for a short sale of on-the-run government bonds.¹⁶ (ii) The proceeds from shortselling on-the-run bonds are used to finance purchase of off-the-run bonds in expectation of a narrowing yield spread between the two bond vintages. (iii) Using the long position in off-the-run bonds as collateral for a loan through a REPO, and investing the proceeds in higher yield floating rate notes (FRNs) issued by investment banks. (iv) Investor lending those FRNs to the issuing bank in

another REPO agreement, continuing to earn the floating-rate coupon on the FRNs (which is higher by assumption than the rate it has to pay for the REPO). (v) Using the cash from the last REPO to make an investment through a derivatives instrument-e.g., buying a call option on equity of firms targeted for a takeover.

The hypothetical strategy outlined above can help shed light on the case of the LTCM fund already mentioned. On-balance-sheet leverage ratio for LTCM rose from a factor of 25 at the beginning of 1998 to 167 at the height of the fund's troubles in the fall of the same year- according to news reports (as already mentioned above). But the (undefined) off-balance-sheet leverage ratio jumped from a factor of 270 to 2100 (referred to in Breuer, 2000). Although LTCM controlled \$ 125 billion total positions (consisting of a large number of trades) on its books with only \$ 2.2 billion in capital, derivatives extended its overall exposure to \$ 1.25 trillion of notional off-balance-sheet positions. These positions consisted primarily of futures contracts on various exchanges, interest rate swaps and other types of OTC derivatives positions (Mehrling, 2001; Basle Committee on Banking Supervision, 1999). The LTCM strategy unravelled during the times of market turbulence in the fall of 1998, following the Russian debt moratorium. Actually, the highly leveraged positions taken by LTCM may have amplified the exogenous price shock generated by the Russian crisis.

Another case in point is the failing energy giant ENRON, which provides yet a glaring example of high leverage and the risks it engenders- particularly in connection with large and complex institutions. The ENRON debacle revealed how the company created "special purpose vehicle" (SPV) partnerships that shifted debts and losses out of its own accounts. The overwhelming majority of derivatives instruments were not quoted, so it was ENRON and its auditors that determine the value of derivatives contracts, and as a result, the level of its profit (Fleuriet, 2003)

IV- Financial Crises: Bad Policies or Systemic Dysfunction?

The global financial environment has been radically changed with the widespread use of

derivatives. It may be said that derivatives have brought about a tectonic change of sorts in the international financial system. In this context, the failure to foretell the Asian crisis may be in some sense analogous to the failure to foresee the Titanic catastrophe. In the very words of the IMF in its 1997 *World Economic Outlook*: “it is difficult to argue (purely on the basis of macroeconomic factors) that the Asian economies in 1996 were poised for the kind of turmoil that afflicted them in 1997 and 1998” (IMF, 1997). And a turmoil it has been, as the data in Table (6) vividly demonstrate. It is significant and perhaps also curious to note that the words of the IMF remarkably echo those of the captain of “The Titanic”, as he just could not comprehend the kind of turmoil that afflicted his “exceptionally strong” boat and sent it on a race to the bottom of the North Atlantic.¹⁷ There may be a “Titanic syndrome” in all this.¹⁸ Curiously enough, the IMF concluded in his 1998 *International Capital Markets* report that the 1996 macroeconomic situation of the Asian countries was by and large better than the situation of Mexico in 1994 (IMF, 1998: 63). It is thus legitimate to raise the question: if macro fundamentals were indeed largely sound, why and how did the crisis erupt? If bad policies were not apparently to be the root-cause, what triggered the crises?

In approaching this question, we maintain that by analogy to the Titanic disaster, the IMF, like the captain of the Titanic, failed to take cognizance of the global financial environment within which the Asian crisis unfolded. And so the turmoil ensued. There are clear systemic factors at work, not just the policies adopted by individual countries. In the remainder of this section, we catalogue additional features of international financial industry which clearly imply that even if the country policy were sound, financial crises may still erupt. So in addition to good macro policy by individual countries, there is a dire need for rethinking the architecture of the international financial system.

(i) **The power of hedge funds/ highly leveraged institutions (HLIs).**

Hedge funds are investment pools, typically organized as private partnerships and often resident offshore for tax and regulatory purposes. Although it may be impossible to accurately define HLIs, they may be characterized as large financial

institutions which operate mainly through offshore financial centres. These funds are very difficult to monitor: they are usually large in size and their activity is global in nature; so far, they are subject to limited or no disclosure requirements or direct regulatory oversight; and they take on considerable leverage (Financial Stability Forum, 2002; BCBS, 1999). The bulk of hedge funds are managed out of the US and the UK, with the funds still largely located in offshore centres. Reference has already been made to the LTCM fund. We also noted that Fidelity, one of the largest mutual funds in the US, has more than \$ 900 billion under management.¹⁹ This is more than four times the stock market capitalization in the MENA region, for example.²⁰ If we plausibly assume that the size and monopoly power are strong correlates, this underscores the significant monopolistic structure of financial markets, or at least some segments thereof. Drawing a parallel between global finance and a water system, opening a canal between the great American lake and the small Egyptian pond (or even Lake Nasser) would seriously trigger flooding in the latter. There is clearly a need for appropriate dams or “sands in the wheel”- some capital account regulation.

Hedge funds/highly leveraged institutions (HLIs) have experienced phenomenal growth in recent years. The hedge fund/HLI industry is conservatively estimated to have grown to about \$ 400-500 billion of capital under management by the third quarter of 2001.²¹ This is up from \$ 175-300 billion at the end of 1998. According to the Financial Stability Forum, a record net capital of US\$22.3 billion flowed into the industry during the first three quarters of 2001, compared to only US\$8 billion for the whole of 2000.²² This makes it a very fast growing industry. The recent acceleration of capital flowing into hedge funds comes against the backdrop of lower returns delivered by those funds compared to the past. This may be explained by the fact that, on average, they have outperformed more traditional equity investment instruments (FSF, 2002).

In addition to the acceleration of capital flowing into the hedge funds, several important trends continued over the past few years (FSF, 2002):

- The number of hedge funds has increased from an estimated 2500-3500 funds in 1998

to about 4000-5000 in 2002, with a parallel decline in the average size of funds.

- A growing share of recent acceleration of inflows to the hedge fund industry has come from institutional investors (pension funds, insurance companies, endowments and foundations).
- Although the majority of funds are managed out of the United States and the United Kingdom (with the funds still located in off-shore centres),²³ there has been an increase in hedge fund assets under management in Europe.

(ii) **The might of LCFIs.**

The last decade has witnessed intensified merger and acquisition drive in the financial sector, motivated by economies of scale and scope. The result was the ascent of large and complex financial institutions (LCFIs). Because they involve a conglomeration of financial service providers in banking, insurance securities and asset management undertakings, LCFIs differ from “solo” financial institutions in that their balance sheet, operations and internal controls are generally more complex and less transparent. LCFIs pose both domestic and cross-border challenges. Such challenges extend beyond the financial sector to the real economy through a web of real-financial linkages.²⁴ The special complexity and size attributes of LCFIs jointly give rise to three categories of challenges (Johnston *et al.*, 2003):

- * regulatory and supervisory;
- * moral hazard (too big to fail, asymmetric information, and adverse selection);

and

- * contagion.

In the light of the fast growth of hedge funds/HLI and the rise of LCFIs, four main concerns are particularly pressing:²⁵

- (a) The systemic risk arising from the accumulation of high levels of leverage in financial markets;
- (b) The potential market and economic impact of a sudden and disorderly collapse of an LCFI or unregulated hedge fund- witness the cases of ENRON and LTCM.
- (c) The potential market dynamic issues relating to HLIs’ activities in small and

even medium-sized open economies (the Locust swarms scenario); and

(d) The possibility that large and concentrated positions in derivatives markets could amplify market pressures, and that aggressive trading practices could compromise market integrity.

V- Capital Mobility and Crises: A South View :

As the discussion above indicates, the structure of the international financial system has undergone “tectonic” changes since the collapse of the Bretton Woods system of fixed exchange-rate regime in the early 1970s. Now, it is in dire need for drastic and fundamental re-engineering. This issue is of critical concern to the South, who has been the big loser as a result of the frequent, even accelerating, eruption of financial crises (Oxfam America, 2002). Reference has already been made to the severe negative effects of the East Asian crisis in terms of loss of income and livelihood, rising unemployment, and increased poverty (Haggard, 200). In this context, the continuous disconnection between this troubling reality and the unfounded faith in the virtues of the free movement of capital is unsettling. Such global policy makers as the IMF and G7 continue to hold the position that, although free and unfettered capital movement has some drawbacks, it is nevertheless better than the alternative of capital controls. A case in point which deserves attention in this regard is the Group of 22.²⁶ In addition to losing their effectiveness over time, according to the Group’s report, such controls are by nature disruptive, engender micro distortions, and create opportunities for rent-seeking. Furthermore, when imposed on capital outflows, they tend to deter capital inflows and “may reduce the pressure for needed policy reform and adjustment and thus exacerbate underlying economic problems.” (Group of 22, 1998: 32).

The Group of 22 seems to be in the good company of the IMF, who continues to hold its old position in favour of instituting the liberalization of capital accounts. Actually, the Interim Committee had agreed in April 1997 that there would be benefits to amending

the Articles of Agreement of the IMF such as to extend the Fund's jurisdiction to capital movements. That amendment was actually on the agenda for the annual IMF/World Bank meeting in Hong Kong in the fall of 1997, but it was temporarily shelved because of the East Asian financial crisis. As a former senior IMF official argued, the proposed amendment "could be restored to the agenda: the Fund could be given the orderly liberalization of the capital account as one of its purposes....., when ready and willing (countries) could accept the obligation of an open capital account." (Fischer, 2002: 13-14). During the annual IMF/World Bank meetings in October 1998, the governors endorsed the concept of a new international financial architecture based on four tenets: increased transparency; consolidation of banking supervision; partnership with the private sector; and orderly, cautious progress toward liberalization of capital accounts.

In the 'bailout' packages for the East Asian countries, further liberalization of cross-border financial flows was one of the conditions set by the IMF and the US Department of Treasury for extending official loans to the crisis-stricken countries. The IMF position in favour of the liberalization of capital flows was re-iterated in a recent issue of its *Research Bulletin*: "Fundamentally, the removal of capital controls appears to be an important step on the path to development, and no country can isolate itself from the market (at least for very long) without hurting its economic prospects." (Tamirisia, 2001: 2).

Implicit in the position of the IMF, G7, and Group of 22 is the extension of the theorem of the optimality of competitive equilibrium to international money and finance. But as argued by Stiglitz and Tobin, problems of moral hazard, adverse selection and asymmetric information, which are particularly widespread in the field of capital and finance, strip that theorem of its basis. Advocates of capital account liberalization have to base their policy position on a different theoretical underpinning. So far, no such alternative has been developed. We would like to carry the regulation argument one step further by stressing yet other reasons justifying capital controls. The first is simply that in the field of international finance, there is virtually no competitive market to speak of. The trend towards establishing large and complex financial institutions (LCFIs) was

noted in section IV above. Such LCFIs, command resources or manage funds that dwarfs not only an entire emerging market economy, but perhaps all emerging markets taken together. Second, the phenomenal growth of financial derivatives involving high leverage and the increasing ability of offshore financial institutions to create liquidity without being accountable to any regulatory body. This points to a big gap in the international financial system: by analogy central banks at the national level were created to regulate the money-creating activity of commercial banks. The world financial system currently lacks such a critically needed regulatory body. Although an institutional structure for international financial supervision is emerging, as manifested by such arrangements/organs as the World-Bank-IMF Financial Stability Assessment Programme (FSAP), BIS, ISOCO, IAIS, FSF in addition to the IMF, it does not adequately perform the enforcement function. In this context, the proposal by Eatwell and Taylor to establish a World Monetary Authority to combine all the functions of authorization, information, surveillance, enforcement and policy makes a good sense (Eatwell and Taylor, 2002).

A third reason is that international markets in capital are prone to error, and the punishment for big financial mistakes tends to extend to other parties *via* contagion. So, it is not necessarily bad policies by individual countries that may cause financial crises; dysfunction of the international financial system is the basic root-cause. Fourth, the macroeconomic environment of free capital flows is plagued with the famous “triad of incompatibilities”, or the “impossible trinity”: it is impossible to have free movement of capital, exchange rate stability, and monetary autonomy (Fischer and Reisen, 1993). Finally, the emergence of the euro as a full-fledged currency beginning 2002 may potentially increase instability of currency and financial markets. In such an environment, free movement of capital, particularly short-term FPI, may increase the tendency to trigger financial crises.

VI- Concluding Remarks:

In the previous sections, we have tried to underscore the role played by derivatives in engendering volatility in financial markets and in triggering financial crises. As already noted above, a constellation of factors contributed to the surge in flows of capital to emerging markets during the 1990s. Among these factors are the liberalization of the capital account in many emerging market countries and the improved macroeconomic fundamentals (falling fiscal deficits and declining inflation) and structural adjustment policies. Changes in global conditions (the decline in nominal interest rates in world money markets) also gave a spur to capital flows to emerging markets.

As already indicated before, structural changes in international financial markets in the 1990s have influenced both the scale and composition of capital flows to emerging markets. The growing importance of portfolio flows (both bonds and equities) has reflected the extended role of such financial innovations as securitization (FRBNY, 2002). During the 1990s, the growing role of institutional investors such as mutual funds, insurance companies, pension funds and hedge funds joined by reshaped banks in their new roles (universal banking), have become major buyers of emerging markets securities (BIS, 2002). This ushers in a totally new era in financial terms, the era of the commoditization of credit. Figures are telling. Net portfolio investment flows to emerging markets took a quantum jump from US\$ 17 billion in 1990 to well above US\$ 106 billion in 1993 (IMF, 1998). Unchecked massive and sudden movements of capital into and out of emerging market economies greatly undermine even good economic fundamentals in a small open economy.

Another perspective which is insightful in this regard, and which has been relatively neglected in the literature is Minsky's financial instability hypothesis. It holds that "over a period of good times the financial structure of a dynamic capitalist economy *endogenously* develops from being robust to being fragile, and that once there is a sufficient mix of financially fragile institutions, the economy becomes susceptible to debt

deflation.” (Bellofiore and Ferri, 2001: 21). A case may be made on the basis of the above against the uncalculated rush to liberalize capital transactions in the balance of payments, particularly in developing countries.

It thus does help to explain what is essentially the outcome of a faulty international financial system on the policies implemented by individual countries- especially the developing ones. Nor does it help to take the outbreak of financial crises as inevitable, and then to look for ways of “managing” them. After all, prevention is better than cure. Reforming the international financial system in this direction deserves to occupy the top of the agenda of the world community. Such reform requires, among other things, putting in place a mechanism for internalizing the effects of the activities of the big players in the international financial game.

Figure (1) FDI & FPI: Gross vs. Net 1970-1997

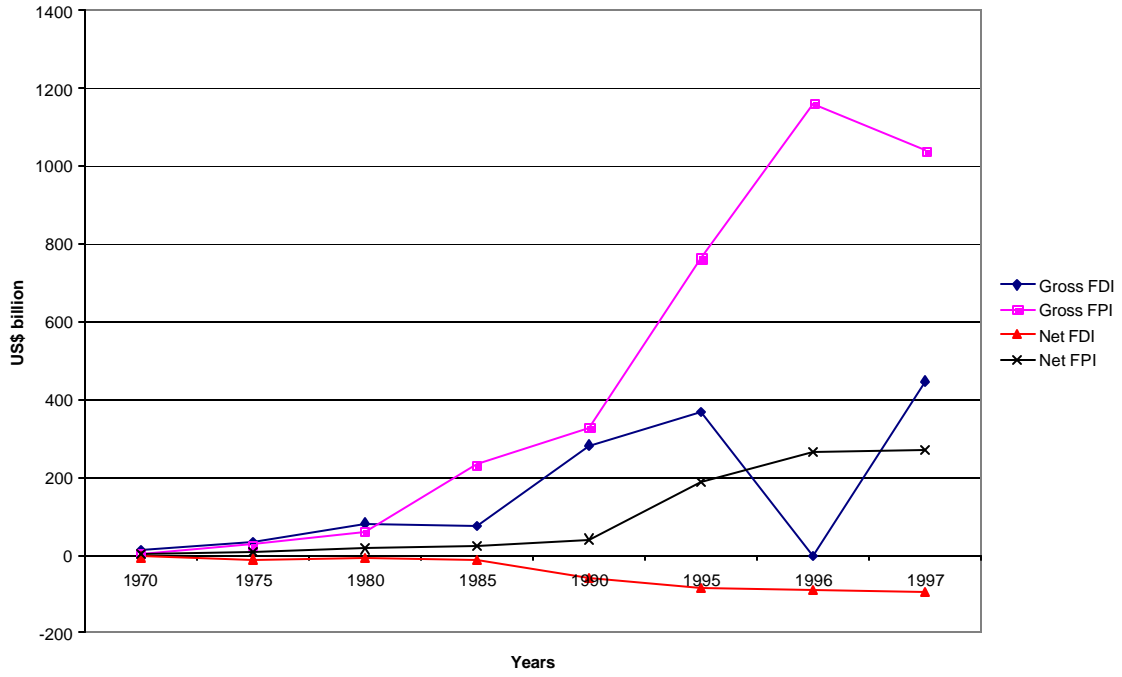


Figure (2) Cross Brdr Transactions in Securities 1975-1997

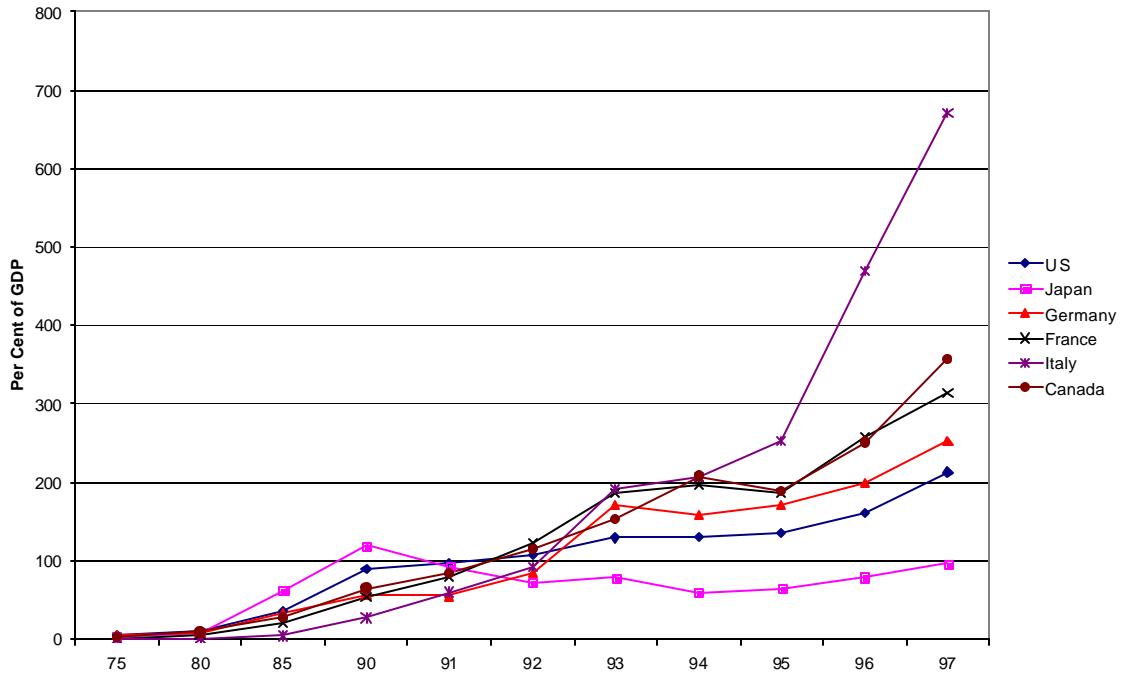


Table (1) G7 Cross-Border Capital Flows, 1970 1997

US\$ billion)

	1970	1975	1980	1985	1990	1995	1996	1997
Gross FDI	14.45	34.25	82.82	75.94	283.24	396.01	357.53	448.32
Gross FPI	5.26	27.1	60.93	233.44	329.63	764.34	1162.64	1040.19
Net FDI	- 4.05	- 9.93	- 8.14	- 12.66	- 59.58	- 83.18	- 87.41	- 92.6
Net FPI	1.42	8.53	16.02	25.03	41.36	186.53	267.37	272.51

Source: IMF, 19988.

Table (2) Cross-Border Transactions in Bonds and Equities in Major Industrial Countries;
1995-1997
(US\$ billion)

	197 5	198 0	198 5	199 0	199 1	199 2	199 3	199 4	199 5	199 6	199 7
Canada	3	9	27	65	83	114	153	208	189	251	358
France	na	5	21	54	79	122	187	197	187	258	313
Germany	5	7	33	57	55	85	170	158	172	199	253
Italy	1	1	4	27	60	92	192	207	253	470	672
Japan	2	8	62	119	92	72	78	60	65	79	96
United States	4	9	35	89	96	107	129	131	135	160	213

Source: IMF, 1998

Table (3) Emerging Markets: Correlation between Changes in NASDAQ Index and Equity Prices

Country	1995-1996	1999-2002Q1
1- Argentina	0.16	0.25
2- Brazil	0.14	0.50
3- Chile	0.09	0.30
4- Hong Kong	0.32	0.61
5- S. Korea	0.28	0.47
6- Malaysia	0.07	0.29
7- Mexico	0.27	0.61
8- Poland	0.16	0.44
9- Singapore	0.11	0.44
10- S. Africa	0.09	0.52
11- Taiwan	0.07	0.34
12- Thailand	0.20	0.31

Source: BIS, Annual Report 2002.

Table (4) Amounts Outstanding of OTC Derivatives¹

June 2000-December 2002

(US\$ billion)

	Foreign Exchange	Interest Rate ²	Equity-Linked	Other ³	Gross Credit Exposure ⁴	Total Contracts	Memo Item: Exchange-traded contracts
Notional Amounts							
June 2000	15,494	64,125	1,645	12,743	---	94,008	13,606 ⁵
Dec 2000	15,666	64,668	1,891	12,975	---	95,119	14,278
June 2001	16,910	67,465	1,884	13,496	---	99,755	19,522
Dec 2001	16,748	77,568	1,881	14,982	---	111,178	23,798
June 2002	18,075	89,995	2,214	17,280	---	127,564	24,083
Dec 2002	18,469	101,699	2,309	19,260	---	141,737	23,874
Average Growth Rate	8.8	25.4	10.5	21.2		22.1	29.3
Gross Market Values							
June 2000	578	1,230	293	472	937	2,572	
Dec 2000	849	1,426	289	618	1,080	3,183	
June 2001	773	1,573	199	500	1,019	3,045	
Dec 2001	779	2,210	205	594	1,171	3,788	
June 2002	1,052	2,468	243	687	1,316	4,450	
Dec 2002	881	4,267	255	956	1,511	6,361	
Average Growth Rate	1.9	73.0	- 6.1	24.4	18.3	41.4	

Source: Bank for International Settlements.

Notes: ¹ All figures adjusted for double counting. Notional amounts outstanding have been adjusted by halving positions vis-à-vis other reporting dealers.

Gross market values have been calculated as the sum of the total gross positive value of contracts and the gross negative value of contracts with non-reporting counterparties.

² Single currency contracts.

³ Includes commodity contracts adjusted for double-counting, and estimated positions of non-regular reporting institutions.

⁴ Gross market value after taking into account legally enforceable bilateral netting agreements.

⁵ Value for December 1999.

Table (5) Derivatives Financial Instruments on Organized Exchanges, 1999-2002
 (Notional Principal in billions of US dollars)

	Dec. 1999	Dec. 2000	Dec. 2001	Dec. 2002
FUTURES				
All Markets	8305.8	8359.5	9672.5	10340.4
Interest rate	7924.8	7907.8	9265.3	9958.5
Currency	36.7	74.4	65.6	47.3
Equity index	344.3	377.3	341.7	334.5
OPTIONS				
All Markets	5299.9	5918.5	14125.5	13540.1
Interest rate	3755.5	4734.2	12492.8	11759.8
Currency	22.4	21.4	27.4	26.6
Equity index	1522.1	1162.9	1605.2	1753.8

Source: BIS.

Table (6) Economic and Social Conditions Before and After the East Asian Crisis

	Indonesia	Malaysia	S. Korea	Thailand
Annual per capita GDP growth				
1990-96	5.7	7.0	6.3	7.0
1998	-14.4	- 9.3	- 6.6	-10.8
Annual inflation (consumer price index)				
1990-96	8.8	4.2	6.0	5.0
1998	57.6	5.3	7.5	8.1
Annual growth of private consumption per capita				
1990-96	6.8	5.4	6.5	6.4
1998	-4.7	-12.6	-10.2	-15.1
Unemployment rate				
1996	4.9	2.5	2.0	1.8
1998	5.5	3.2	6.8	4.5
Poverty incidence				
1996	11.3	8.2	9.6	11.4
1998	20.3	na	19.2	13.0

Source: World Bank, as reported in Haggard, 2000, p.191.

ENDNOTES:

¹ Just as an example which epitomizes the polarization of views about the issue, my home town (Cairo) hosted two gatherings almost simultaneously in October 2002. In a pro-globalization gathering venued in a five star hotel, James Wolfensohn, President of the World Bank, spoke to an assembly of government high officials, think tank members, representatives of international organizations, the media, and top brass professional economists. Simultaneously, a group of anti-globalization thinkers and activists addressed a large and varied audience in a modest hall.

² There are other indicators suggested by IMF which are variations of interest rate differential: (i) interest differential between the cost of interbank funds denominated in some currency in two capital markets; (ii) covered interest-rate differentials; (iii) deviations from uncovered interest parity (UIP); and (iv) departures from real interest rate parity. Fischer and Reisen add another indicator: independence of domestic saving and investment ratios (IMF, 1991; Fischer and Reisen, 1993).

³ In fact, FPI flows grew much faster than any of the other types of capital flows. Their share of total private capital flows to developing countries rose phenomenally between the 1970s and the 1990s. See World Bank, (2000).

⁴ NASDAQ stands for National Association of Securities Dealers Automated Quotations.

⁵ Their integration index may be defines as

$$II = 1 - [\text{Var}(R_i | R_e^*) / \text{Var}(R_i)]$$

Where, R_i = return on security which belongs to the i th market that is accessible only to its nationals,

R_e^* = the vector of return on all securities that can be bought by all investors irrespective of their nationality.

The value of II ranges between zero (for complete segmentation) and 1 (for complete integration).

⁶ The 1998 merger of Deutsche Termin Börse and the Swiss Options and Financial Futures Exchange into EUREX paved the way for the creation of Europe's most actively traded interest-rate contracts- the euro-bund and euro-bobl futures. EUREX thus emerged as the world's largest derivatives exchange (IMF, 2001: 22). This development is related to the introduction of the euro and the concomitant shift of organized exchange trading of long-term interest rate derivatives from London to Frankfurt.

⁷ This method has its origin in the days when the instruments were literally bought over the counter of a bank. The current meaning refers markets which have no specific location, with fewer rules governing trading, and which may be more international in character. Trading takes place directly using various communication media such as faxes and the internet rather than via a highly regulated exchange floor. (Reuters, 1998).

⁸ Market risk is the risk of movements in prices. Value-at-risk (VAR) methodology is used to deal with market risk. Credit risk is the potential nonpayment of a counter-party to another. Liquidity risk is the risk that a holder of a financial instrument may not be able to sell or transfer that instrument quickly and at a reasonable price. Operational risk is the risk that improper operation of trade processing or management systems will result in financial loss. Settlement risk is the risk of nonpayment through a settlement system, and is related to credit risk and operational risk.

⁹ This is usually done through offshore banking units (OBUs), which are shell branches owned by nonresident banks in an international financial centre. It accepts deposits from foreign banks and other OBUs and makes loans in the Eurocurrency market, unrestricted by the local monetary authorities or governments. Such financial units have sprung up since the 1970s in major European cities, the Middle east, and the Caribbean. Eurocurrency markets, or simply Euromarkets, are markets in financial instruments based on currency held outside its country of origin. The prefix “Euro” does not mean that such instruments (called Euroloans or Eurobonds) are held by a financial institution in Europe or traded there. The name has its origin in the historical fact that these markets first developed in Europe, primarily in London. Unlike foreign bonds (such as Yanki bonds and Samurai bonds), Eurobonds are creatures of the global capital markets, *free of domestic regulation*, even though they may be quoted and traded in specific local markets (Houthakker and Williamson, 1996).

¹⁰ Since 1985, the number of financial innovations has leveled off as the different derivative instruments tend to reach a ceiling. Although customers are confronted with new products almost everyday, they are just known derivatives for new assets. Basically, derivatives are futures, options and swaps; all other derivatives are developments, extensions, combinations of those three basic structures - particularly options and swaps. (Reuters, 1998; Rothstein and Little, 1984).

¹¹ In most exchanges, to take a long options position you pay the full notional amount plus a premium. However, on the London International Financial Futures exchange (LIFFE), options are traded futures style; both the buyer and the seller pays just a margin (Reuters, 1998:75).

¹² Total gross leverage equals On-balance-sheet assets plus notional amounts of outstanding derivatives contracts as a percentage of regulatory capital. Regulatory capital refers to Tier 1 and Tier 2 capital.

¹³ Margin on stock transactions is 50%. This is in fact a down payment. But haircuts on repos are only between 1 and 2 percent. Margin on exchange-traded futures is between 2 and 8 percent. According to Breuer, some hedge funds have even been able to negotiate a zero margin. A 4 percent price movement on a few trillion dollars worth of assets used as collateral in a repo (as experienced in the LTCM debacle in the fall of 1998) would trigger massive margin calls, resulting in a major market turbulence (Breuer, 2000; Rothstein and Little, 1984).

¹⁴ The London International Financial Futures Exchange (LIFFE) is an important exception, where options are traded futures style: both buyers and sellers pay margin. In this case the buyer of an option does not pay the whole premium up-front as a single payment (Reuters, 1998).

¹⁵ Margin payments may be in cash. But this is just one way of posting collateral; securities are frequently used for posting collateral- i.e., for margin payment (Breuer, 2000).

¹⁶ On-the-run securities are the latest issue of a given maturity. Off-the-run securities are the previous issues of the same maturity. The market for on-the-run securities is usually more liquid than that for off-the-run ones.

¹⁷ Those who built the Titanic failed to take cognizance of the fact that at the time of the boat’s maiden voyage across the north Atlantic (early April), the waters are usually pretty cold. Given the steel-making technology at the time, the steel hull of the boat turns fairly brittle in such very low temperature; waiting to crack on any impact.

¹⁸ After viewing “The Titanic” on the screen, I could not get any sleep the whole night. The scene when bottom cabin passengers were not allowed to flee for their life to the deck distressed me gravely. I kept thinking: what went wrong?, and I came up with the answer: the Titanic syndrome. It means that when societies create things and believe they had perfected them (the ship Titanic, the Asian tigers, etc.) they fail to take the necessary precautions. When disaster strikes, they are caught unawares and helpless; it is too

late to do anything.

¹⁹ Figures are as of March 31, 2001. Established in 1946, the company now boasts 17 million customers, making it the leading mutual fund company and a leading discount broker. (Information from www.fidelity.com as of April 14, 2003).

²⁰ The combined total stock market capitalization of Egypt, Jordan, Kuwait, Lebanon, Morocco, Oman, Saudi Arabia, Tunisia, Turkey, and the United Arab Emirates amounted to about \$ 246 billion in 2000. See ERF, 2002, Table A2.1.

²¹ Data from various sources are not totally consistent. The figure above is from Financial Stability Forum (2002), and they do not tally with the capital under management by Fidelity which was reported above.

²² Figures have to be viewed with caution in view of the special nature of this industry: it is difficult to define hedge funds precisely; they are not subject to public reporting requirements; and their activity is global in nature.

²³ The most important off-shore centres are Aruba, Andorra, Belize, Costa Rica, Lebanon, Macau SAR, Marshall Islands, Monaco, Netherlands Antilles, Seychelles, Vanuatu, Anguilla, Antigua, and Barbuda, Bahrain, Barbados, The Bahamas, Bermuda, British Virgin Islands, Cook Island,s, Guernsey, Isle of Man, Jersey, Liechtenstein, Labuyan (Malaysia), Malta, Mauritius, Samoa, St Kitts and Nevis, St Lucia, St Vincent, and the Grinadines, The Turks and Caicos, Nauru, and Niue.

²⁴ For example, Johnston *et al.* Report that Swedish LCFIs constitute the backbone of the banking and financial industry not only in Sweden, but in the entire Nordic region and Baltic states. The largest Swedish LCFI Nordia Group, for example, accounted for market shares of 40%, 25%, 20%, and 11% in Finland, Denmark, Sweden, and Norway, respectively. Two Swedish institutions, SEB and Swedbank, together owned more than 90% of Estonia's banking sector (Johnston, *et al.*, 2003)

²⁵ Most of these concerns were voiced by the Financial Stability Forum in its 2002 Report.

²⁶ The group consists of 22 of "systemically significant" economies: Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, South Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa, Thailand, the United Kingdom, and the United States. The heads of the BIS, IMF, OECD and the World Bank, as well as the Chair of the Interim Committee, participated as observers. They met in Washington, D.C. in April 1998 to examine issues related to the Stability of the international financial system and the effective functioning of global capital markets.

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