TAMING GLOBAL FINANCIAL FLOWS

Challenges and Alternatives in the Era of Financial Globalization:
A Citizen's Guide

KAVALJIT SINGH

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1

Recent Trends in Global Financial Flows

SINCE the breakdown of the Bretton Woods system of fixed exchange rates in the early 1970s, the phenomenal increase in global financial flows is the most significant development in the world economy. Globalization of finance is not a new phenomenon as there was massive cross border movement of capital without any restrictions for 50 years prior to the First World War (1914-18). But the stupendous increase in global financial flows in both absolute terms and pace of movement in the post-Bretton Woods period has been unparalleled and as such has given rise to serious concern among policy makers and observers. The growing global financial integration could be gauged from the exponential rise in the volume of foreign exchange trading. According to the BIS, which monitors transactions in the world's foreign exchange markets, $1.49 trillion ($1490,000,000,000) is traded on an average every single day.

Box 1.1

Bretton Woods System

In July 1944, the procedure for fixing exchange rate and managing international financial system was worked out at a conference held in Bretton Woods, a town in New Hampshire in the US. The Bretton Woods system was designed to ensure that domestic economic objectives were not subordinated to global financial pressures. Under the Bretton Woods system, all countries were required to fix exchange rate to the US dollar, and the dollar was fixed in terms of gold at $35 an ounce.

Since the US emerged as the leading power after World War II, the dollar replaced the sterling as the dominant currency for exchange. Under this system, private financial flows were regulated by capital controls and an international institution, IMF, was set up to monitor the international financial system that was largely dominated by official capital flows. The Bretton Woods system was not universal in its outreach as the communist bloc was not part of it.

However, the rise of Eurocurrency market in the 1960s put strains on the Bretton Woods system. The system suffered a major breakdown on August 15, 1971 when the US — which was unable to deal with a massive speculative attack on the dollar in the wake of growing balance of payments deficit largely caused by the protracted Vietnam War — unilaterally declared that it would no longer honor its commitment to exchange dollars for gold at $35 per ounce. For some time, a few countries attempted to create alternatives (e.g., the Smithsonian Agreement) to the defunct Bretton Woods system. But on February 12, 1973, Japan decided to float the yen against the dollar, and on March 16, 1973, the European Community followed suit. Thereafter, the remaining countries took recourse to either floating or flexible exchange rate system.

Undoubtedly, this system was based on the hegemony of the US as it served the country's foreign policy and economic interests. Surely, the motive was not altruism on the part of the US but was based on the expectation that the country had much more to gain from managing international financial system. Despite its several shortcomings, this system provided adequate financial stability and economic growth for a considerable period.

In the initial years of the Bretton Woods system, international flow of capital was heavily controlled. For instance, it was not possible for a British investor to buy American stocks or bonds. The bulk of external capital available to developing countries was in the form of official aid and grant. FDI flows to developing countries, other than for exploitation of natural resources, were extremely low while commercial bank lending and portfolio investment flows were almost nonexistent. By the early 1960s, markets had found ways for circumventing some of these controls through the growth of 'Euromarkets,' where banks located in one country could take deposits and make loans in the currencies of other countries. After the collapse of the fixed exchange rate system in the early 1970s, the developed countries led by the EEC and the OECD countries gradually started dismantling controls on capital movement. The US soon followed suit to attract capital inflows, particularly from Germany and Japan.

The oil shock of 1973-74 soon followed leading to heavy surpluses in oil-exporting countries and corresponding deficits in oil-importing countries. Many oil-exporting countries preferred to keep surplus funds in Western commercial banks, which then needed investment outlets. They turned to the developing countries (particularly the Latin American countries) that were anxious to borrow funds to tide over balance of payments deficits. Thus, the recycling of 'petrodollars' from the surplus to deficit countries via the Eurocurrency market created a significant surge in global financial flows. Net flows to developing countries from commercial banks reached their peak by the late 1970s.

The excessive build up of external loans in the developing countries coupled with higher interest rates in the developed countries triggered the debt crisis as many developing countries were unable to service their huge external debts. There is no disagreement with the observation that several countries had mismanaged the use of external funds so much so that a major chunk of these funds were diverted towards conspicuous consumption or simply disappeared into the pockets of politicians and officials. Only a minor proportion went into productive investments. But, at the same time, international banks cannot be absolved of their role in

perpetuating the debt crisis as they relaxed their credit criteria in order to reap huge profits from the recycling of 'petrodollars.' In 1982, when Mexico announced a moratorium on its repayment, the international banks realized that they were in thick soup as other developing countries in Latin America facing similar problems might follow suit. As heavy exposures to indebted countries was posing a threat to the Western banking system, several debt management packages (e.g., Baker Plan and Brady Plan) were set in motion by the developed countries and international financial institutions and groupings, particularly the IMF and the Paris Club, to rescue commercial banks. Consequently, the developing countries were net recipients of global financial flows in the early 1980s. In other words, new loans to the developing countries exceeded interest payments and repayments of principal. However, with the beginning of debt crisis in 1982, this pattern was completely reversed, as there were substantial net transfers from the developing to the developed countries. During the latter half of the 1980s, foreign capital flowed mainly within the developed countries.

In the aftermath of the debt crisis, the implementation of structural adjustment programs in several Latin American countries led to large-scale private capital inflows. With emphasis on privatization, liberalization and removal of controls on capital account, adjustment programs facilitated a renewed surge in global financial flows to several Latin American countries, particularly Mexico and Chile. In the case of Mexico, NAFTA also played a crucial role in facilitating capital inflows. The region witnessed a sharp increase in capital inflows, from $53 billion in 1995 to $74 billion in 1996. A large part of this increase emanated from equity flows through depository receipts and investments by institutional investors.

Apart from the Latin American countries, the greatest recipients of financial flows were the Southeast Asian countries known as 'Asian Tigers.' However, the reasons for capital inflows in the Southeast Asian countries were entirely different from the Latin American countries, as much of the financial flows were directed towards setting up of assembling

and manufacturing facilities in these countries. As the currencies of 'Asian Tigers' were generally pegged to the dollar, they benefited from the rise of Yen against the dollar following the Plaza Accord of 1985. The euphoria created by the global investment community in the 1990s was so high that countries previously known as developing or third world countries earned the epithet of emerging markets.

Global Financial Flows to the Developing Countries in the 1990s

One of the most striking developments regarding global financial flows is the radical change in their configuration in the 1990s, particularly in the context of developing countries. Based on the data published by the World Bank in its various publications including *Global Development Finance 1999*, some of these trends and developments are summarized here.

Table 1.1: Net Long-term Resource Flows to Developing Countries (1990-98) *($ billion)*

	1990	1994	1995	1996	1997	1998*
Net long-term resource flows	100.8	223.6	254.9	308.1	338.1	275.0
Official flows	56.9	45.5	53.4	32.2	39.1	47.9
Private flows	43.9	178.1	201.5	275.9	299.0	227.1
From international capital markets	19.4	89.6	96.1	149.5	135.5	72.1
Private debt flows	15.7	54.4	60.0	100.3	105.3	58.0
Commercial banks	3.2	13.9	32.4	43.7	60.1	25.1
Bonds	1.2	36.7	26.6	53.5	42.6	30.2
Others	11.4	3.7	1.0	3.0	2.6	2.7
Portfolio equity flows	3.7	35.2	36.1	49.2	30.2	14.1
Foreign direct investment	24.5	88.5	105.4	126.4	163.4	155.0

Note: Net long-term resource flows are defined as net liability transactions of original maturity greater than one year. Although the Republic of Korea is high-income country, it is included in the developing country aggregate since it is a borrower from the World Bank.
* Preliminary.

Source: World Bank, *Global Development Finance 1999*, 1999, p. 24.

- Net long-term financial flows to the developing countries, both private and official, increased from $100 billion in 1990 to $338 billion in 1997. However, it declined to $275 billion in 1998 due to the Southeast Asian financial crisis and its contagion effects (see Table 1.1). In 1997, the developing countries made a net transfer of financial resources abroad to the tune of $27 billion — the first negative transfer since 1990.

- Private capital flows dominate the total financial flows to the developing countries. Out of the $338 billion of total financial flows in 1997, private flows accounted for $299 billion, nearly 88 per cent of the total flows.

- Official capital flows, both bilateral and multilateral, are on the decline, from $56 billion in 1990 to $39 billion in 1997. Official flows are, however, critical to the economies of several African countries. Most of them still remain dependent on official capital flows to meet their requirement of external finance.

- The bulk of private capital flows are highly concentrated, with a dozen countries receiving nearly three-quarters of capital inflows during the period 1990-97, while 140 of the 166 developing countries accounted for less than 5 per cent of total flows during the same period. China is the leading developing country which has attracted substantial amount of private capital flows, particularly FDI, in the nineties. As mentioned earlier, the recent surge in private capital flows which occurred in Latin America and Southeast Asia has largely bypassed Sub-Saharan Africa (except South Africa).

- In the 1990s, a substantial part of private capital flows has gone to the private sector as compared to the governments just a decade ago.

- FDI flows have emerged as the most important component of private capital flows and remains predominant despite several financial crises in the 1990s.

- Flows from international capital markets (portfolio investments, bonds and bank loans) have increased considerably in the 1990s, from $19

billion in 1990 to $149 billion in 1996. Portfolio investment (PI), which was negligible during the 1970s and 1980s, became sizeable in the early 1990s. From $3 billion in 1990, PI flows increased to $49 billion by 1996. Borrowings through commercial bank loans have also registered an increase. It was $43 billion in 1996, an increase of $12 billion from 1995. The majority of borrowers of commercial bank lending belong to the private sector, accounting for nearly 60 per cent of all new loans during 1995-96. Another noticeable aspect of commercial bank lending is that nearly half of it is used to finance mega infrastructure projects like power, highways, etc. Given the extreme volatility associated with such financial flows, the flows from international capital markets declined from $135 billion in 1997 to $72 billion in 1998 in the wake of the Southeast Asian financial crisis.

- Flows from international capital markets have been highly concentrated in the middle-income countries, which received more than 90 per cent of these flows during the 1990s.

Factors Behind the Surge in Global Financial Flows

A number of factors, both external and internal, have contributed to the increase in global financial flows. Some of the key factors are discussed in the succeeding pages. Needless to add, these are the contributory factors, which have engendered volatility and instability in the global financial system.

Global Financial Liberalization

Financial liberalization in both the developed and the developing countries is perhaps the most important factor behind increased capital mobility on a global scale. Although a detailed analysis of financial liberalization and its consequences is given in the next two chapters, a brief introduction may suffice here. Financial liberalization has two interrelated components, domestic and international. Domestic financial liberalization encourages market forces by reducing the role of the state in the financial sector. This is achieved by removing controls on interest rates and credit allocation as

well as by diluting demarcation lines between banks, insurance and finance companies.

International financial liberalization, on the other hand, demands removal of controls and regulations on both the inflows and outflows of capital. By allowing cross border movement of capital, it promotes global financial integration. Due to increased global financial integration, the flow of funds is no longer unidirectional. Capital is not only flowing from the developed to developing countries but also from the developing countries (e.g., Mexico, Chile and Thailand) to the rest of the world.

Developed countries were the first to embark on the process of financial liberalization. Foreign exchange markets took the lead to liberalize in the late 1970s. The liberalization of capital account was followed by liberalization of bond markets in the 1980s, and equity markets in the 1990s. In addition, the growing institutionalization of savings in the developed countries has given rise to institutional investors who are both willing and able to invest in global financial markets. Much of financial assets in developed countries are now finding their way into mutual funds, hedge funds, pension funds and investment trusts rather than banks. For instance, in 1980, banks handled 58 per cent of savings and investment transactions in the US economy, and institutional investors held a 31 per cent market share. By 1994, the banks' proportion had fallen to 33 per cent and that of institutional investors had jumped to 44 per cent.[1]

Since the 1980s, the size and the structure of financial markets of developing countries have also undergone rapid changes. Deregulation of domestic financial markets along with liberalization of capital account have been important components of the adjustment programs supported by the World Bank and the IMF. During 1991-93, 11 developing countries undertook full or extensive liberalization of their exchange restrictions; 23 liberalized controls on FDI flows; 15 eased controls on portfolio inflows; and 5 eased restrictions on portfolio outflows. By the end of 1995, 35 developing countries had fully open capital accounts. A significant part of the surge in foreign equity financing has been associated with the

privatization of public sector companies in the developing countries (e.g., Argentina), which also happens to be an important component of the adjustment programs. The number of countries that are classified as highly integrated increased from 2 in 1985-87 to 13 in 1992-94, whereas the number of countries classified as moderately integrated increased from 24 to 26.[2]

Apart from the structural adjustment program, several international agreements have also promoted financial liberalization in the developing countries. For instance, financial liberalization is an important component of the WTO agreement on financial services concluded in 1997 and the IMF's Article VIII obligations of convertibility of currencies for current account transactions. Under the WTO agreement on financial services, which came into effect from March 1998, 70 of its member-countries agreed to open up their financial services sector. This agreement brings trade in financial services — worth trillions of dollars — under the WTO's rules on a permanent and full most favored nation (MFN) basis. By this agreement, countries representing over 95 per cent of the trade in banking, insurance, securities, asset management and financial information, have brought financial services into the realm of international rules. While the number of countries which have accepted the IMF's Article VIII has increased sharply from 35 in 1970 (which was only 30 per cent of the membership of the IMF) to 137 in early 1997 (76 per cent of its membership).[3]

Over-capacity and Overproduction

From the beginning of the 1980s, the economies of the developed countries are suffering from over-capacity and overproduction in manufacturing. Their problems have been further compounded by the intrusion of the 'Asian Tigers' into the world markets during the 1980s and the 1990s. With no major expansion in the world's markets taking place, capital is looking for alternative profitable opportunities. As mentioned earlier, the global financial markets are expanding exponentially. Since profits can be made quickly in financial markets, much of the capital is shifting away

from investment in production to investment in financial markets and speculative financial instruments. This shift in international economy has become more apparent in the 1990s.

Historically, wealth was created when income was diverted from consumption into investment in machinery, buildings and technological change. Nowadays, securitization — the issuance of stocks and bonds — has become the new instrument of wealth creation. As financial logic becomes more important than productive logic, the managers and owners of business corporations are more concerned with rewarding their shareholders in order to boost the value of shares in the financial markets. Many tend to sacrifice long-term investment goals for short-term profits and higher stock prices. In fact, several manufacturing firms have also started financial subsidiaries in order to benefit from finance capital. The General Electric Capital Services (GE Capital) — a subsidiary of the world's largest TNC, General Electric (GE) — is a classic example of this trend. With $255 billion in assets worldwide, GE Capital is a major player in global financial markets. In 1997, it contributed as much as 40 per cent to the parent company's total income.[4] A recent entrant into financial services is UPS Capital, a subsidiary of United Parcel Service, the world's largest courier company.

Low International Interest Rates

Among the external factors, perhaps the most important one is the relatively low real rates of return available on investments in the major developed economies from where large funds originate. For the past so many years, the interest rates are extremely low in the developed countries as compared to the developing countries. For instance, interest rates on treasury bills in the US are in the range of 4 to 5 per cent while long-term interest rates in Japan are perhaps the lowest in the world, i.e., less than 1 per cent. This prompts investors in developed countries to seek alternative markets for their investments in the developing countries where the interest rates are much higher.

Technological Advances

Major advances in the technological field, especially in communications and information, have played a supportive role in the globalization of financial markets. The influence of technological advances has broken the natural barriers of space and time as twenty-four hours trading is possible now, which was not the case a decade ago. Virtual stock exchanges are no longer a dream, thanks to advances in Internet technology. The 'electronic money' has added momentum to capital mobility as funds can be transferred globally with much ease and speed with the help of globally linked electronic monitors. With the help of SWIFT payments system, billions are transferred every day.[5] The advances in communications have drastically reduced the costs in moving money around the world. Wire-transfer systems such as FedWire and CHIPS (Clearing House Interbank Payments System) are also commonly used worldwide. With the adoption of International Accounting Standards (IAS), uniformity in accounting standards will soon become a reality thereby further facilitating the cross border movement of capital. However, technological advances have also increased the speed at which market shocks are transmitted nationally and globally. Earlier, market shocks used to take days and weeks to spread from one country to another, now they can be transmitted instantly.

The Domination of Finance Capital over the Real Economy

Due to the cumulative impact of the factors cited above, the global financial system has undergone tremendous change and has become much more complex and unruly than it was twenty years ago. New financial instruments and financial intermediaries have not only drastically changed the landscape but also the basic function of the global financial system. Much less regulated than the real economy, the financial economy has outgrown the real economy and has considerably blurred the existent relationship. The global financial markets have moved beyond their original function of facilitating cross border trade and investment. The financial markets are no longer a mechanism for making savings available for

productive investments. Nowadays, global financial flows are less associated with the flows of real resources and long-term productive investments.

As the value of global foreign exchange trade is many times more than the value of annual world trade and output, much of global finance capital is moving in search of quick profits from speculative activities rather than contributing to the real economy. Since 1980, the global stock of financial assets (shares, bonds, bank deposits and cash) has increased more than twice as fast as the GDP of rich economies, from $12 trillion in 1980 to almost $80 trillion today.[6]

The swift cross border movement of capital has very little to do with the national or the world allocation of capital funds. Every day, trillions of dollars move in the world's financial markets in search of profit making opportunities from speculative investments. These flows are largely liquid and are attracted by short-term speculative gains, and can leave the country as quickly as they come. It has been calculated that over 80 per cent of spot forex turnover have a maturity of less than seven days.[7] Commercial and merchant banks, in addition to hedge funds, carry out most of the arbitrage and speculative dealing in foreign exchange and money markets.

Although not much attention has been paid, the globalization of finance can give rise to serious social, economic and political problems. According to Phil Cerny, the global finance capital "calls the tune for the real economy... it has developed its own autonomous structural dynamic, a dynamic with regard to which international politics has yet to find a workable consensus on objectives or a feasible method of control."[8] There are several ways in which the domination of finance capital negatively affects the real economy. Firstly, by providing economic incentives to gamble and speculate on financial instruments, the global finance capital diverts funds from long-term productive investments. According to Susan Strange, the real economy of manufacturing, services like entertainment, tourism, transport, mining, farming and retailing — all of it dances to the fast or slow rhythms of financial markets.[9] Secondly, it encourages banks and financial institutions to maintain a regime of higher real interest

rates which significantly reduces the ability of productive industries and enterprises in terms of access to credit. Thirdly, finance capital (because of its speculative nature) brings uncertainty and volatility in interest and exchange rates. This volatility is extremely harmful to various sectors of the real economy, particularly trade. Lastly, it undermines efforts by governments to support full employment and reduce inequality.

In order to arrive at a better understanding of the operations of global finance capital, some of its key features as well as recent developments are outlined here.

Foreign Exchange Trading: Scaling Unprecedented Heights

The foreign exchange market is the largest market in the world today. As mentioned earlier, over $1.49 trillion is traded on an average every single day, whereas in 1977, the daily turnover in forex markets was just $18 billion. Since the breakdown of Bretton Woods system in the early 1970s, forex transactions have increased several times (see Table 1.2). Quite often, analysts tend to underestimate the significance and power of foreign exchange and money markets. It would be a serious mistake to underestimate the importance of these markets because the price at which

Table 1.2: Daily Global Forex Turnover, 1977-98

($ billion)

Year	Daily Turnover
1977	18.3
1980	82.5
1983	119.0
1986	270.0
1989	590.0
1992	820.0
1995	1190.0
1998	1490.0

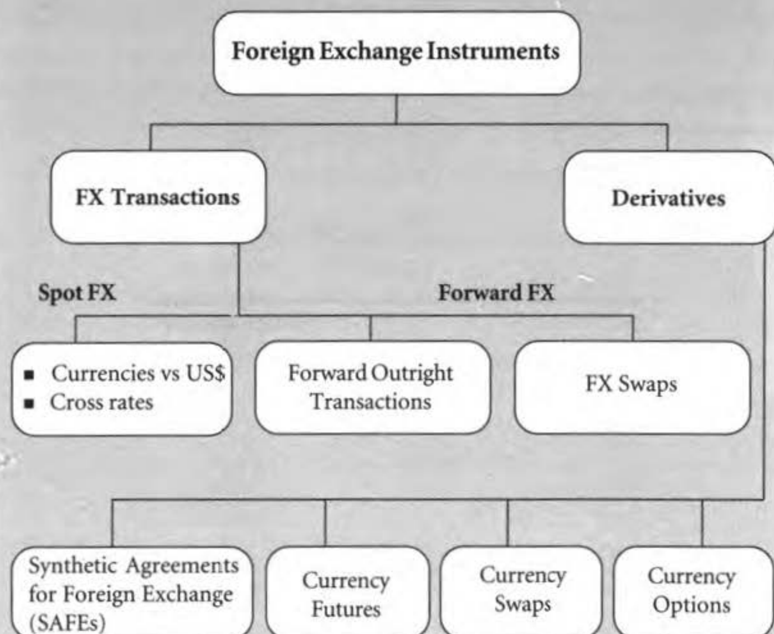
Source: Bank for International Settlements.

Box 1.2

Foreign Exchange Trading

Foreign exchange is traded over-the-counter (OTC) twenty-four hours a day. OTC transactions are those that take place between two counterparties located anywhere in the world via a telephone or electronically rather than traded on an exchange. The main methods of forex trading are via direct interbank using systems (e.g., Reuters Dealing 2000-1), voice brokers and electronic broking systems (e.g., Reuters Dealing 2000-2). Some forex instruments are also traded on exchanges such as currency futures at the Chicago Mercantile Exchange and currency options at the Philadelphia Stock Exchange.

There are three broad categories of instruments and transactions in forex trading — spot transactions, forward transactions and derivatives (see diagram below). **Spot transaction** is a deal in which two counterparties exchange two different currencies at an agreed exchange rate for settlement



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in two-business days time. In 1998, spot transactions amounted to 40 per cent of the daily turnover of foreign exchange, down from 44 per cent in 1995. **Forward transactions** involve purchase or sale of foreign exchange established now but with payment and delivery at a specified future date. These transactions are derived from spot forex and money market interest rates. The two types of forward forex transactions used widely in the markets are forward outright transactions and forex swaps. In the past few years, forward transactions have grown in importance relative to spot transactions. Of the $1.49 trillion daily turnover in foreign exchange in 1998, nearly $900 billion was traded in forward transactions, approximately 60 per cent of the market. In 1995, its market share was 56 per cent. **Derivative instruments**, which are concerned with forward transactions of forex, include currency futures, currency swaps, currency options and Synthetic Agreements for Foreign Exchange.

Forex markets are driven by a number of factors including relative interest rates, balance of payments, money supply, political factors and market sentiments. Rumors have a powerful impact on the forex market. The way the forex markets react to rumors could be summarized by the phrase: Buy the rumor, sell the fact! Speculation makes up the largest portion of trading in the forex market. The major participants in the forex market are banks as nearly two-thirds of daily foreign exchange transactions take place through interbank trading. Only a small portion of foreign exchange transactions directly involve non-financial customers who import and export goods and services. The rest of the transactions involve forex traders, forex dealers and securities firms.

Although participants in the foreign exchange markets are spread all over the world, London is the largest foreign exchange trading center, followed by New York, Tokyo and Singapore. The most actively traded currencies in the forex markets are US Dollar, Deutsche Mark and Japanese Yen. These three currencies together constitute 69 per cent of the global forex trade. Much of forex trading is carried out by a handful of dealers consisting of banks and institutional investors. According to *Euromoney*, the top 10 dealers are Citibank, Deutsche Bank, Chase Manhattan, Goldman Sachs, HSBC Midlands, JP Morgan, SBC Warburg Dillon Read, Merrill Lynch, Netwest and Industrial Bank of Japan.

money is bought and sold dictates the economic policies of national governments and therefore affects the lives of billions of people.

Why do we need forex markets? The main function of forex markets is to facilitate cross border trade and investment. As different countries use different currencies, forex markets convert one currency to another currency for cross border deals. Another function could be to hedge against the risk. Historically, much of the trading in foreign exchange was the result of international trade, as buyers and sellers of foreign goods and services needed another currency to settle their transactions. In the early 1970s, about 90 per cent of forex transactions were related to trade and investment. But now, forex trading has very little to do with international trade as most purchases and sales of forex are related to financial transactions rather than merchandise trade. In fact, forex trading has grown much faster than international trade in goods and services. In 1997, the global volume of exports of goods and services was $6.6 trillion ($5.2 trillion of goods exports and $1.3 trillion of services exports). This comes to only approximately 4 days of global forex trade. If one compares global forex trade with the world GDP ($29.2 trillion in 1998), it is more than ten times the world GDP. Hence, the forex market is much bigger than all the other markets put together. These comparative statistics bring out the fact that forex trading has gained a life of its own as there is a growing delinking between forex transactions and real economic activities, with the former far exceeding the financing requirements of the latter. These statistics also reveal that speculation makes up by far the largest proportion of trading in the forex market.

But the foreign exchange markets are very volatile and therefore pose a systemic risk. As banks are involved in much of forex trading, they are exposed to large amounts of cross border settlement risk. Given the fact that national payment systems operate in different time zones, it is possible that after the first counterpart has delivered one side of the transaction, the other counterpart may go bankrupt and fail to deliver the offsetting currency. Because of increased inter-bank lending by international banks, a default by one large bank may cause a second bank to fail which in turn

may lead to a larger systemic upheaval in the international banking system. Thus, any debacle in the settlement of foreign exchange transactions could have serious negative implications for the global financial system.

The Emergence of Securities

Besides global foreign exchange trade, the other important factor that has contributed to the spectacular growth in finance capital is the emergence of securities. Since 1980, the volume of trading in financial securities has increased phenomenally. The value of global financial securities is more than the value of annual world output. The total dollar value of all investment-grade securities worldwide that could potentially be issued is upward of $150 trillion, roughly five times the value of annual world output.[10] The growth of new financial instruments, such as derivatives, has further increased the volume of trading. As there are no reliable statistics of financial derivatives, it is estimated that the total outstanding notional value of derivative products was over $80 trillion in 1997. The world bond market has grown from $2 trillion in 1980 to $25 trillion in 1998.[11] According to Capital DATA (a company which monitors financial

Table 1.3: US Institutional Investment

Proportion of US equity market (in percentage) owned by institutional investors		Proportion of US equity market (net worth) owned by institutional investors (1997)	
Year	**%**		**$bn**
1950	6.1	Private pension funds	1709
1960	12.6	Mutual funds	1586
1970	19.4	Public pension funds	1213
1980	33.9	Bank and trust companies	803
1990	47.2	Insurance companies	303
1997	48.0	Other institutions	614

Source: The Conference Board.

markets), 3850 international bonds were issued by the top 25 investment banks in 1998 alone.[12] Led by Merrill Lynch, the top five leading issuers accounted for 37 per cent of the value of these bonds.[13]

Mutual funds have also witnessed a massive expansion since the 1980s. Mutual funds represent the second largest pool of private capital in the world after the banking industry. It has been estimated that US will enter the 21st century with half of all households owning shares directly or through mutual funds, compared with 25 per cent in the mid-1980s and only 5 per cent in the 1950s.[14] While pension funds represent the third largest pool of private capital in the world, after the banking and mutual fund industry. The value of global pension assets grew by more than 60 per cent, from $6 trillion in 1992 to $9.7 trillion in 1997.[15] As far as hedge fund industry is concerned, they are estimated to be at least 5500, with $300 billion of funds under management, as of mid-1998. By and large, the increase in financial assets is more pronounced in the developed countries where the process of securitization has been accompanied with the development of international institutional investors. According to OECD data, the total institutional assets of the main regions in the OECD domain rose from $3.2 trillion in 1981 to $24.4 trillion in 1995.[16]

The rapid growth of financial securities, however, raises some critical issues. In the recent years, there has been no parallel rise in the real economy despite the rapid rise in the value of global financial securities. In fact, the opposite is true because the growth in real economy has been the slowest in the post war period. In the US, for instance, where stock markets have witnessed a massive boom in the 1990s due to massive inflow of funds, growth in market capitalization has far outstripped the growth in output. Similar trends have also been witnessed in the employment and productivity growth rates in the US.

The assumption that borrowers can raise funds directly from investors through securities rather than going to other sources is difficult to accept for two reasons. Firstly, the trillions of dollars flowing into financial markets account for resale or trading of stocks in secondary markets. The corporation issuing the stock does not get this money which goes to the

last owner of the stock. For instance, when shares of Ford Motor are bought and sold, the company's capital and physical assets do not change and there is no increase in its profits. What has changed is the ownership of the company. That is why many market observers argue that a more apt definition of institutional investors in securities should be institutional traders because they basically trade financial instruments and know when to make a killing. Only a small part of these huge sums enters the corporate real economy in the form of new issues sold in primary markets. Even new issues may not contribute to additional investment if the proceeds are used to retire other domestic debt or fund current expenditures or are mobilized for speculative purposes by the corporation.

Secondly, it is an established fact that banks are much more important when firms are building up a reputation. Once firms have established a reputation, only then equity and bonds markets have some role as providers of investment finance. Even in countries with a high level of development, new equity finance plays a very minor role in providing finance for investment. A study of eight developed countries found that net financing raised through short-term securities, bonds and shares is extremely small — less than 5 per cent.[17] By and large, corporations in most of the developed countries raise their financial resources internally. From 1945 to 1995, US non-financial firms raised 75 per cent of their finances internally, 12 per cent from intermediaries such as banks and 13 per cent from the security market.[18] In the case of certain other developed countries, corporations raise fewer funds from the market, for instance, Germany 3 per cent and Japan 7 per cent.[19] In several studies, Ajit Singh of University of Cambridge has demonstrated that equity markets in the developed countries are not effective either in ensuring an efficient allocation of savings or in encouraging efficient decision making by entrepreneurs.[20]

In the case of India, new equity raised in the market has declined over the years. According to the data provided by Centre for Monitoring Indian Economy, new equity raised in the market declined from Indian Rupees (Rs.) 3470 million in 1994-95 to Rs.1150 million in 1998-99, even as market capitalization on the Bombay Stock Exchange registered an increase

from Rs.43340 million to Rs.54290 million over the same period. It is highly unlikely that equity finance will play a significant role in the developing countries where equity markets are underdeveloped. Further, in several developing countries (e.g., India and China) where the financial markets had been liberalized in the 1990s, corporations have raised lesser amount of funds from the market. Singh found that "there is little or no evidence of an increase in aggregate savings for most developing countries as a result of greater new issues activity on the stock market. In some of the countries (e.g., Turkey and Malaysia) aggregate savings actually fell during the 1980s."[21]

Securitization poses new problems and threats to macroeconomic stability. Trading in securities is influenced more by speculation rather than by economic fundamentals. Rumors play an important role in the trading. Because of high liquidity, funds can move out quickly thereby causing a steep fall in the value of stocks, assets and exchange rates. A sudden loss of confidence among foreign investors can cause a dramatic outflow of funds thereby creating conditions of an imminent financial crisis. This is precisely what happened in the recent Southeast Asian financial crisis.

The Great Transformation of Global Banking

The global banking system has witnessed a radical paradigm shift in recent years due to financial deregulation and liberalization. Historically, banks were the leading intermediaries but now non-bank financial intermediaries play a major role in the global financial system. As financial markets led by non-bank financial institutions have become more dominant than money markets, the power and influence enjoyed by the banks in the past has drastically weakened. Nowadays, banks compete with mutual funds and other non-banking financial institutions to attract funds. Thanks to megamergers taking place in the global banking industry, a trillion-dollar bank has now become a reality (see Box 1.3). In 1998, 505 merger and acquisition deals transferred $285 billion in market value and $1.22 trillion of assets, including megamergers of Citicorp-Travelers

Box 1.3

A $1000,000,000,000 Bank on the Cards?

A trillion-dollar bank! In the past, it was almost impossible to imagine such a gigantic bank. Given the pace at which megamergers are taking place in the banking industry these days, the world will soon witness not one but several trillion dollar banks. The French bank, Banque Nationale de Paris (BNP) made a bid in early 1999 to buy two other French banks, namely, Societe Generale and Paribas. Interestingly, both Societe Generale and Paribas had just entered into a friendly merger when the BNP launched its bid. If the bid by BNP works out, it would create the world's biggest bank, with assets over $1 trillion. Some other recent megamergers include Swiss Bank with Union Bank of Switzerland; Citicorp with Travelers Group; Nations Bank with Bank of America; and Deutsche Bank with Bankers Trust. Except BNP, other megamergers could not produce a trillion-dollar bank though some are inching toward it. It appears that merger mania never stops, as it becomes a self-perpetuating cycle. One merger deal leads to rise in share prices, which in turn, further provides the fuel for the next merger deal and so on, ad infinitum.

In the race to the trillion dollar mark, Japanese banks are also not lagging behind. Under a major financial restructuring plan announced in mid-1999, several megamergers between Japanese banks are on the anvil. If these megamerger deals proceed smoothly, Japanese banks may again become the biggest banks in the world, as was the case a decade ago when they reigned. The proposed tie-up of three big Japanese banks — Fuji Bank, Dai-Ichi Kangyo Bank and Industrial Bank of Japan — would create the largest bank in the world in terms of assets worth $1.27 trillion. Similarly, the deal between Sumitomo and Sakura banks to merge by April 2002 will create an entity worth $934 billion in assets.

While megamergers provide fodder for front-page stories in the newspapers, a simple fact is often ignored that mergers pose new challenges to regulatory authorities in terms of moral hazard. The complexity of big banks makes the task of managing risk more difficult. This became evident in 1998 when UBS suffered huge losses on account of bad deals in financial derivatives and lending to a hedge fund, LTCM. Recently, the BIS has come out with a critical study which found that mergers have failed to boost profits. Further, job cuts are an imminent fallout of every merger deal. Deutsche Bank's merger, for instance, with Bankers Trust was accompanied by a staggering downsizing of 5500 jobs.

Group and Nations Bank-Bank of America.[22] With the emergence of universal banking, the trillion dollar banks would provide a range of financial services including stock brokerage, insurance, mutual funds and Internet banking. Megamergers of banks, in fact, have been facilitated by financial deregulation and therefore should be seen as an integral part of a bigger phenomenon.

Largely because of increased competition and low margins in retail banking, banks have expanded their businesses in the last two decades. As a result, the distinction between the operations of commercial banks and non-banking financial institutions is getting blurred with the emergence of investment banking and universal banking. Similarly, many non-banking institutions have now ventured into banking services. For

Box 1.4

Financial Intermediary is an agent who deals with the general public on the one side and the financial markets on the other. The important function of financial intermediary is to bring together economic agents who wish to save with those who wish to invest.

Commercial Bank is a commercial institution that accepts deposits and makes credit to private individuals, companies and other organizations.

Investment Bank helps firms raise money in the financial markets. They underwrite issues by agreeing to buy unsold securities. They also advise their clients on mergers and acquisitions.

Universal Banking involves not only services related to loans and savings but also those involved in making investments in companies. Well developed in Germany, the Netherlands and Switzerland, universal banking system allows banks to act as investment banks and to provide a very wide range of other financial services to clients.

UK Building Societies are involved in both lending and borrowing funds in the money markets since 1982. In their financial transactions, the building societies resemble high street banks. The first building society to become a bank in the UK was the Abbey National.

instance, building societies in the UK now offer cheque accounts. Likewise, the launching of financial and banking services by several business corporations (e.g., the General Electric of US and Tesco, a chain of departmental stores in the UK) has further intensified this trend.

In the past, several countries had adopted policy measures to prevent commercial banks from acting as universal banks providing different financial services such as investment banking and underwriting insurance. In the US, for instance, the Glass-Steagall Act of 1933 was enacted in the wake of the Great Depression of the 1930s to prohibit universal banking. Under the Act, commercial banks were prohibited from investment banking activities, such as underwriting corporate securities. However, under pressure from market forces, the US repealed the Glass-Steagall Act in 1999. With massive financial deregulation, the original separation between commercial and investment banking has been drastically eroded in recent years as banks now take up discount brokerage operations, sell mutual funds and provide underwriting and other investment services. Rapid changes in the financial sector (e.g., emergence of financial derivatives) have also facilitated the diversification of banks into various non-fund businesses. Some banks have even diversified into the insurance services through mergers and acquisitions. In Germany, for instance, a new type of banking called Allfinanz has emerged which offers life insurance, pension schemes and traditional bank deposits. The list of universal banks includes Citigroup, Deutsche Bank, Dresdner Bank, Commerzbank and HSBC.

On the other hand, investment banks (e.g., Morgan Stanley Dean Witter and Co., Merrill Lynch, Goldman Sachs and Credit Suisse First Boston) help corporations to raise funds in financial markets. They also advise their clients on mergers and acquisitions. Much of the income earned by investment banks comes from fees and commissions. As investment banks indulge in heavy risk businesses (such as financial derivatives), their profits are relatively higher. Notwithstanding the growing trend of commercial banks taking on investment banking services, there are few success stories. In fact, several big banks such as Citicorp and

NatWest have abandoned their investment banking operations.

Recent experience, particularly in the context of the Southeast Asian financial crisis, also raises critical issues about the operations of investment banks. When the crisis broke out, several investment banks were blamed for speculating on Asian currencies and thereby causing the crisis. But curiously, some of them have become advisors to the crisis-ridden countries. Goldman Sachs, for instance, is advising Thailand and Indonesia on bond issues and privatization while Lehman Brothers is a consultant to the Financial Restructuring Agency of Thailand that is selling off assets of closed finance companies. It is ironical that while advising the Thai authorities on restructuring, Goldman Sachs in collaboration with GE Capital was busy bidding to buy up the assets of 56 defunct finance companies. Since these banks have commercial enterprises in Thailand and Indonesia, analysts have pointed out that banks are pursuing their own business interests without any compunction. None other than Thailand's Finance Minister, Tarrin Nimmanahaeminda, has echoed this concern:

> These banks have an advisory side and a wheeler-dealer commercial side...They always say they maintain Chinese walls between them. I rather doubt it. How else would they be proving to their board that they are maximizing profits?[23]

Financial Derivatives: The Source of Systemic Risks

Another major development in the global financial system is the explosive growth of financial derivatives in the 1980s and the 1990s. In fact, the growth in derivative markets has been more dramatic in comparison with the equity and bond markets. Trading of derivatives in raw minerals and goods dates back to the nineteenth century, while financial derivatives started in 1972 with currency trading. Stock-index futures trading began in 1982, and trading in interest-rate futures commenced in 1988. The derivative markets are not restricted to developed countries alone. A number of developing countries allow trading in derivative instruments. There are no reliable statistics pertaining to financial derivatives. From the end-March 1995 to the end-June 1998, notional amounts outstanding

in the OTC markets rose by 52 per cent touching $72 trillion, compared with $13.2 trillion outstanding in exchange traded foreign exchange and interest rate derivatives which grew by 34.2 per cent, according to the latest estimates published by the IMF.[24]

While financial derivatives are supposed to help reduce risk, they have become one of the biggest sources of volatility and instability in the global financial markets. Derivatives pose additional risks because many of the contracts are highly speculative thereby increasing the chances of heavy losses if a bet goes sour. Speculators play an important role in the trading of financial derivatives. They keep buying and selling contracts

Table 1.4: Markets for Selected Derivative Instruments, 1991-96

	Estimated amounts outstanding at year-end ($bn)					
	1991	**1992**	**1993**	**1994**	**1995**	**1996**
Exchange traded instruments	3519	4634	7771	8863	9188	9885
Interest rate futures	2157	2913	4959	5778	5863	5931
Interest rate options[a]	1073	1385	2362	2624	2742	3278
Currency futures	18	27	35	40	38	50
Currency options	63	71	76	56	43	47
Stock market index futures	76	80	110	127	172	199
Stock market index options	133	159	230	238	329	380
Over the counter instruments	4449	5346	8475	11303	17713	24292
Interest rate swaps	3065	3851	6177	8861	12811	
Currency swaps[b]	807	860	900	915	1197	
Other swap-related derivatives[c]	577	634	1398	1573	3705	
Total	**7968**	**9980**	**16246**	**20166**	**26901**	**34177**

[a] Calls and puts.
[b] Adjusted for reporting of both currencies.
[c] Caps, collars, floors and swaptions.
Source: *Annual Report*, Bank for International Settlements, 1996-97.

Box 1.5

Derivatives: Trader's Dream, Regulator's Nightmare

A derivative product is a contract, the value of which depends on (i.e., 'derived' from) the price of some underlying asset (e.g., an interest level or stock market index). Financial derivatives are financial contracts whose value is based upon the value of other underlying financial assets such as stocks, bonds, mortgages or foreign exchange. They are contractual agreements for future exchange of assets whose present value are equal. However, the value of the derivatives will change over the term of the contract as market valuation change the value of each side of the contract. The key element in these derivatives is that one can buy and sell all the risk of an underlying asset without trading the asset itself.

Trading in financial derivatives is also distanceless and borderless. Financial derivatives are either transacted OTC or traded at exchanges. There are specialist exchanges (e.g., London International Financial Futures Exchange) in which financial derivatives are traded. However, in recent years, the value of OTC instruments has increased sharply as compared to exchange-traded instruments. While exchange-traded instruments are strictly regulated, OTC contracts are informal agreements between two parties and therefore carry heavy risk. The main users of financial derivatives are banks, forex dealers, corporate treasurers, institutional investors and hedge funds.

Recent experience shows that financial derivatives are largely used as tools to make profits from speculation and arbitrage rather than to reduce exposure to risk. From the nineties onwards, trade in derivatives has registered a rapid growth in terms of volume of trading and in the evolution of new and far more sophisticated instruments, giving rise to what is known as the 'derivatives of derivatives' syndrome. Due to these developments, it becomes a difficult task to regulate financial derivatives both at the company's as well as state regulatory levels. Financial derivatives, therefore, are going to pose one of the greatest challenges for regulatory bodies in the 21st century. It is high time that regulatory bodies pay adequate attention so that an effective strategy to deal with the systemic risks posed by the financial derivatives can be chalked out.

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The three forms of financial derivatives are options, futures and swaps. **Options** are the rights (without obligation) to buy or sell a specific item — such as stocks or currency — for a preset price during a specified period of time. The option can be freely exercised or disregarded, with no obligation to transact. Where the right is to buy, the contract is termed a **Call Option**; where the right is to sell, it is termed a **Put Option**. The holder of the option is able to take advantage of a favorable movement in prices, losing only the premium payable for the option should prices move adversely. Trade in option contracts was long practiced between banks but developed after these began to be traded on the Philadelphia Stock Exchange in 1982. Currency options were introduced on the London International Financial Futures Exchange (LIFFE) and the London Stock Exchange in 1985. Options on three-month sterling futures were introduced on LIFFE in November 1987; trade in Japanese government bond futures began in July 1987. Chief centers for trade in options are the Chicago Board Options Exchange, the American Stock Exchange, and the European Options Exchange in Amsterdam and markets in Australia, France, Sweden and Switzerland.

Futures are contracts that commit both parties to a transaction in a financial instrument on a future date at a fixed price. Unlike an option, a futures contract involves a definite purchase or sale and not an option to buy or sell. Often futures are used to speculate in the financial markets and therefore considered risky. A forward contract differs from a futures contract in the sense that each forward contract is a once-only deal between the two parties, while futures contracts are in standard amounts traded on exchanges. Unlike forward contracts, futures are traded face to face at exchanges and are regulated by the authorities.

Swaps are agreements in which two counterparties undertake to exchange payments within a specified time period. For example, a UK company may find it easy to raise a sterling loan when they really want to borrow Deutsche Marks; a German company may have exactly the opposite problem. A swap will enable them to exchange the currency they possess for the currency they need. Recent years have witnessed explosive growth in currency swaps and interest rate swaps. The first currency swap was between the World Bank and the IBM in 1981.

fall or remain stable. Instead the interest rates soared. Suffering huge losses, the Orange County defaulted on its loan and went bankrupt. In addition, there was a $40 million cut in the county budget and consequently the government had to drastically slash the budget earmarked for social welfare programs for low-income population. Thousands of workers, as a result, lost their jobs in Orange County.

- Have you ever heard of losing $157 million on a deal involving $200 million of borrowing? In 1993, Proctor and Gamble (P&G), a US conglomerate entered into a deal to reduce the interest costs on $200 million of loans. Under the deal, P&G's interest rates would vary according to a complex formula based on the yields of US Treasury bonds of different maturities. The nominal value of contracts that P&G had entered into was $3800 million. Rather than falling, the interest rates in the US rose. By the time the management of the company decided to extricate itself from the deal, it had suffered a whopping loss of $157 million.

- In 1995, Barings Plc., Britain's oldest merchant bank, suffered a loss of $1.4 billion when its Singapore based derivatives trader Nick Leeson built up large but uncovered positions in Nikkei 225 (Japan's leading share index) futures contracts on the Osaka and Singapore futures exchanges. Leeson was convinced that the Nikkei would rise and therefore he placed one-sided bets on the price movement of Nikkei 225. However, due to the Kobe earthquake in January 1995, Japanese share prices collapsed and Nikkei 225 fell sharply. Leeson continued trading and even increased his exposure after the earthquake. In February 1995, an inquiry ordered by the management to look into his operations found that the bank had suffered huge losses. Apart from the alleged fraud committed by Leeson, lax internal controls were found responsible for the huge losses. By forwarding nearly $890 million (more than half of its capital) to its Singapore subsidiary, Barings had violated the British and the European regulations which limit the funds to be used for any single purpose by a bank.

- The Daiwa Bank suffered losses totaling $1.1 billion when its New York-based branch's dealer Toshihide Iguchi carried out unauthorized

trading in US Treasury bond futures. The problem started when Iguchi made a $200000 trading loss in 1984. For over 11 years, he continued accumulating $1.1 billion of losses by falsifying records in such a manner that neither the Daiwa Bank nor the US Federal Reserve had any clu about it. In July 1994, Iguchi finally informed the Daiwa Bank about his trading losses.

- In 1998, Long-Term Capital Management (LTCM), a hedge fund, suffered a huge loss of more than $4 billion. With the notional value of derivatives contracts exceeding $1 trillion, LTCM was bound to make substantial profits if interest rate spreads on bonds narrowed. However, in the aftermath of the Russian crisis, there was a stampede to 'safety' and yield spreads widened instead of narrowing. By September 1998, LTCM lost 90 per cent of its equity. For details, see chapter 4.

Although much attention has been paid to the role of 'rogue trader' for incurring huge losses (e.g., Leeson of Barings and Iguchi of Daiwa), three underlying factors behind many of these financial disasters have been largely ignored. Since financial derivatives are very sophisticated, risky and highly leveraged instruments, a slight mishandling of trading can lead to huge losses. Secondly, there are serious weaknesses in the internal control and risk management systems within the banks and institutions involved in financial derivatives. Lastly, and perhaps more importantly, regulatory and supervisory authorities have lagged behind in foreseeing the risks involved in the derivatives trading particularly in the OTC derivative markets. There is no denying the fact that the central banks have intervened sporadically to avert the contagion effects of the financial disasters in the financial system. However, the real challenge before central banks and regulatory bodies is to curb speculative behavior and bring discipline in derivative markets so that financial disasters of such magnitude do not recur.

Offshore Financial Centers and the 'Dirty Money'

The world of offshore financial centers (which are also popularly known as 'tax havens') display the characteristic elements of 'casino capitalism.'

There is hardly any region in the world that does not have any offshore financial center. In total, there are over 69 offshore financial centers in the world and the funds routed through these centers are huge. A large number of hedge funds, trust companies, shell companies and brokerage houses are located in offshore centers. Central to financial liberalization, these centers originated primarily for avoiding foreign exchange and capital controls. Closely linked with corruption and crime, these centers are the natural destination of 'dirty money.' Often used for money laundering purposes, the offshore financial centers act as a tool to launder not only the proceeds of drug trafficking and other crimes but also aid and abet certain kinds of financial crime. The BCCI scandal is one of the glaring examples of this phenomenon that shook the world's markets in the early 1990s.

In a similar vein, the global hedge fund industry has witnessed tremendous growth in the past decade. The total number of hedge funds operating worldwide is estimated to be 5500, with $300 billion of funds under management, as of mid-1998. A substantial number of hedge funds operate from offshore financial centers. Since the issues related to hedge funds and offshore financial centers are of special significance and are integrally related to deregulation, they have been examined in detail in chapters 4 and 5 respectively.

Global Financial System: A Casino?

The recent trends and developments in global financial flows, as discussed above, corroborate the fact that international economy has moved away from productive pursuits to those of finance. As the value of global forex trade is many times more than the value of annual world output or export of goods and services, the global financial system resembles a casino in which assets are traded primarily for speculative profit rather than for the benefit of the real economy. That is why, many analysts have described this phenomenon as 'casino capitalism.'[25] In fact, it is 'casino capitalism' that very often perpetuates economic disasters thereby adversely affecting the lives of millions of ordinary people who have put

their savings and assets at its disposal. Even those who are not part of 'casino capitalism' (e.g., poor people, workers, small traders, etc.) may not be able to escape from its machinations as witnessed in the wake of the Mexican and the Southeast Asian financial crises. As Susan Strange puts it succinctly:

> For the great difference between an ordinary casino which you can go into or stay away from, and the global casino of high finance, is that in the latter we are all involuntarily engaged in the day's play. A currency change can halve the value of a farmer's crop before he harvests it, or drive an exporter out of business. A rise in interest rates can fatally inflate the costs of holding stocks for the shopkeeper. A takeover dictated by financial considerations can rob the factory worker of his job. From school-leavers to pensioners, what goes on in the casino in the office blocks of the big financial centers is apt to have sudden, unpredictable and unavoidable consequences for individual lives. The financial casino has everyone playing the game of Snakes and Ladders.[26]

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