“Financial Flows and Global Integration”

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Financial Flows and Global Integration

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Abstract:

This paper focuses on the post-war process of creation of global trading system and integration of world trade. As the former came into being, multilateral trade liberalization became an on-going feature of the global economy facilitating international trade, consequently importance of international trade in the global economy increased dramatically. Since the mid-1980s, mindset regarding trade policy in the developing economies, particularly middle- and high-income ones, began changing in a discernible manner. They liberalized their trade policy regimes and tried to integrate with the global economy. Several developing economies were highly successful in integrating with the global economy through trade. The change in mindset of policy mandarins was clearly visible during the Uruguay and Doha Rounds of multilateral trade negotiations. Although the industrial economies were the primary beneficiaries of the multilateral trade liberalization, for the developing economies trade, particularly trade in manufacturing goods, went on increasing monotonically. The kaleidoscope of global trading system turned several times and international trade has enormously expanded over the preceding half century, which in turn contributed substantially to global integration through trade, albeit in a selective manner.

Keywords: globalization, integration, liberalization, trade

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CONTENTS

1. Introduction
2. Novelty of Financial Globalization
3. Financial Globalization: The Destructive Phase
4. Financial Architecture after the World War II
5. Financial Globalization after the Bretton Woods Failure
6. Financial Globalization and Efficiency
7. Financial Globalization and Growth Nexus
8. Financial Globalization and the Domestic Financial Sector
9. Dimensions of Net Capital Flows to Emerging Market Economies
10. Globalizing Financial Services
11. Conclusions and Summing-Up

1. Introduction

Neither the concept nor the phenomenon of financial globalization can be considered novel. Cross-country capital movements have a long and well-documented history. The principal focus of this paper is to demonstrate that during the contemporary phase of globalization policy makers and economic agents in the emerging market economies began to work towards a more financially integrated world and towards achieving a deeper degree of financial integration. The newest developments in the information technology and effectiveness of public policy further underpinned cross-border financial flows. During the contemporary period, gradually increasing amounts of private capital flows started going to the developing economies. Financial globalization has definitive and obvious efficiency implications. For instance, when capital is free to move globally, its scope widens and it tends to be attracted toward the opportunities of highest return in the global economy. To be sure, it has long-term welfare implications. Contagion and crisis are a vexing and pernicious downside of financial globalization.

The structure of this paper is as follows. In Section 2, the paper shows the lack of novelty of the phenomenon of financial globalization. The Section 3 deals with the reversal in financial globalization during the inter-War period. Section 4 focuses on the creation of the global financial architecture during the post-World War II era. The break down of the Bretton Woods system and creation of a new global financial system has been dealt with in Section 5. The economic and financial aspects of financial globalization have been delved into in the subsequent sections, that is, whether financial globalization contributes to systemic efficiency is discussed in Section 6. The following section analyses the globalization-growth nexus. How financial globalization affects the domestic financial sector is the issue for Section 8. The quantitative dimension of the contemporary net capital flows to the emerging market economies have been discussed in Section 9, while globalizing financial services have been taken up in the next Section. Section 11 provides a brief summery of the paper.

2. Novelty of Financial Globalization

Like technological advancement or long-run economic growth, evolution of global financial integration was not "a record of ever-more-perfectly-functioning markets with ever lower transaction costs and ever expanding scope" (Obstfeld and Taylor, 2002). Long-term growth of global financial markets was far from linear. Vicissitudes in the volume of financial flows were more common than uncommon. There were periods of slow growth in global financial integration, followed by those of rapid growth as well as periods of virtual standstill and reversals. There were periods when global financial integration was limited among a small number of countries, which were grouped in two or three categories and there were epochs when this integration expanded much more widely geographically. Liberalized markets did not enjoy high political popularity. Several periods witnessed strong reactions against market trends, in particular financial markets. In the recent past, in the middle of the twentieth century and towards its end, such cynicism was easy to notice. Reacting to downsides of financial globalization, anti-market and anti-globalization voices became particularly strident towards the end of the last century.

Neither the concept nor the phenomenon of financial globalization can be considered novel. Cross-country capital movements have a long and well- documented history. As regards the answer to the question when and where the international banks were born, some of the earliest ones among them were born in Venice. The Medici family of Venice was among the first wealthy families to successfully venture into international banking in a big way during the Renaissance period.[2] Italian banks developed instruments to methodically finance trade and governments around the Mediterranean. Although global financial flows took place during the Renaissance, geographically they were limited among a small number of source and recipient countries and were far from globalized in their movements. With expansion of trade, international financial systems expanded to other parts of Western and Northern Europe and grew more innovative. Instruments like letters of credit are known to have been working at the Champagne Fairs during this era.

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[2] Lorenzo de Medici took Michelangelo Buonarroti under his wings when Michelangelo was a little boy and provided the right artistic ambiance to him to nurture his genius.

From Italy, international banking expanded to the northern port cities of Bruges and Antwerp, and then to Amsterdam and London, essentially in that order. The last two named financial centers grew enormously and became the two most important hubs of international finance. Currencies and financial instruments developed and used in these two centers were considered the most credible and valuable by the market players of this period. As the industrial revolution spread out of Britain, the international financial markets expanded *pari passu.* With the expansion of economic activity following the industrial revolution, use and significance of the financial instruments created during this period increased between both kinds of market players, public and private.[3]

As economic activity expanded to the so-called New World offshoots of Western Europe, international financial transactions supported it and international financial centers developed in those parts of the New World where the governments were not averse to them and followed supportive strategies. Boston, Baltimore, Philadelphia and Chicago developed as financial centers in the United States (US), which subsequently gave way to New York. Over the years it dominated them and grew to be the domineering financial center of global significance. Towards the end of the nineteenth century, France and Germany succeeded in developing international financial centers of their own. Paris and Berlin emerged as major financial centers during this period, which were well integrated into the global economy. In other part of Europe and the New World similar financial markets began to grow, although unlike France and Germany they began from a low level of initial development. Financial markets in Buenos Aires and Melbourne were born during this period (Davis and Gallman, 2001). As an increasing number of countries actively adopted gold standard, after 1870, development of international finance as well as financial centers were accelerated. A stable exchange rate contributes to the successful development of international financial markets. The technological advancements of this era buttressed their progress.

Using different measures and indicators, several analysts tried to establish that a greater degree of financial globalization existed in the previous epochs of globalization than in the

[3] For the birth and expansion of international banking and finance, please refer to Das (1986), Neal (1990) and Cameron (1993).

contemporary period.[4] One important distinction between financial globalization in the past and that in the contemporary period is that in the past a limited number of countries, and a small number of sectors, participated in financial globalization process. Not the same can be said about the contemporary period. Also, in general capital followed the migration of population and it was *inter alia* utilized in supporting trade flows. Long-term bonds of varying maturity were the most popular financial instruments in the past. Financial activity was highly concentrated in the hands of a small number of freestanding companies, which dominated the arena of global finance. Similarly, a small number of wealthy family groups and their banks dominated financial intermediation in the past.

As shown by the statistical analysis in Section 3, this system was functioning smoothly, if at a somewhat slow pace, until the eve of the World War I. The Great Depression of the 1930s and the World War II added to crises and instability in the global economy. This was a period of economic and financial reverses. Consequently, after the World War II ended, policy makers switched their stance and instead of recreating the smoothly-functioning globalized financial markets of the pre-World War I era, they began making policy moves in the opposite direction by imposing capital controls to regain monetary policy autonomy. Policy makers in positions of responsibility were faced with, what the textbooks call, the Mundellian trilemma, or "impossible trinity", or "inconsistent trinity".[5] An open capital market deprives an economy of the ability to target its exchange rate and to use monetary policy in pursuit of other economic objectives. However, the inconsistent trinity or the policy "trilemma" is only to be taken as an approximation. Economic policy coalesces with the socio-political forces to decide which one of the three policy strands will dominate policy formulation in a particular period.

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[4] Baldwin and Martin (1999) have reviewed the related literature in detail. Several important empirical studies have analyzed this issue. For instance, refer to Obstfeld and Taylor (1998) and Taylor (1998).

[5] Macroeconomic policy regime at best can accommodate only two elements of the following three policy objectives: (i) fixed exchange rates, (ii) autonomous monetary policy oriented toward domestic objectives, and (iii) free cross-border capital mobility.

3. Financial Globalization: The Destructive Phase

Progress in globalization and a smoothly functioning equilibrium in the global financial system was shattered by the World War I. Attempts to return to globalization after the World War I failed because the economic structure of the combatants' economies had undergone a significant change due to the War. This failure led to erection of trade barriers and repeated devaluations of currencies in a competitive manner. This kind of competition turned out to be a destructive phase.

For appearance sake countries maintained gold standard—like gold coinage, and exchange rate pegs—during the World War I but created obstacles in gold and capital movement and ignored the rules of the game. Patriotism supplanted all the considerations of having a smoothly functioning global financial system. The War years of 1915-19 recorded a sudden spurt in global financial movements—leading to a second peak of 5 percent. This capital movement reflected the wartime borrowings of the European economies (Taylor, 1996). Global capital flows began diminishing in volume in 1920. As the War had destroyed the global financial architecture, governments radically altered exchange rates and prices levels and also imposed exchange controls. In the early 1920s European economies tried to re-peg their currencies to gold and after 1925 a fleeting gold-exchange standard was re-established. Many European economies relaxed foreign exchange controls for a short while. This was the period of reconstituted gold standard, or gold exchange standard.

Bordo and Eichengreen (1998) believe that the re-established gold exchange standard of 1925, with capital mobility, would have survived in the absence of the Great Depression, which in turn largely resulted from a disastrous error of the Federal Reserve Board in the US. Their hypothesis was that the gold exchange standard could be suspended during the War years and restored at the end of the War at the original gold parity of $20.67. This system could have lasted until the early 1960s and then would have collapsed because of the Triffin dilemma.[6] Had this hypothetical scenario come true, the global economy would have shifted to the floating exchange rate much earlier than it did. Consequently, financial globalization would not have slowed as much as it did during the twentieth century.

The gold exchange standard finally collapsed in 1931 when the sterling pound—one of the most significant currencies of this period—departed from its gold peg[7]. The three major currency crises of 1931 led to flight from the Austrian schilling, Hungarian the pengo, and the German mark. Increases in discount rate failed to produce the desired results. The grip of flight psychology was so strong that policy makers believed that exchange controls was the only option left to them. Intervention in the foreign exchange markets did not work and the three economies continued to drain their gold reserves. After 1931, when both the classical gold standard and gold-exchange standard had become irrelevant, foreign exchange controls returned causing economic turmoil. Financial instability promoted exchange controls all over the globe, in the core and periphery countries. Although they adopted controls it with alacrity, thinking that they have found the appropriate solution to the problem of financial volatility, many governments found it difficult to manage these controls. Some of the exchange control policies were effective and successful, while others were difficult to implement and unsuccessful. Uncertainty in foreign exchange markets continued and large movements in exchange rates became common.

As the depression deepened, the Latin American economies not only depreciated their currencies but installed exchange controls like the other economies of this period. Many Latin American economies defaulted on their foreign loans, which made them a pariah. Global capital flows to this region virtually stopped (Alejandro, 1983). Given such uncertainties in global economic and financial environment, this turned out to be a lean period for global capital mobility. During the era of Great Depression, financial flows shrank to a meager 1.5 percent of the national income (Taylor, 1996). According to the investment stock approach adopted by Obstfeld and Taylor (2002), foreign assets were only 8 percent of global GDP in 1930, 11 percent in 1938 and merely 5 percent in 1945.

[7] In June 1931, flight from sterling pound began. The British government could not apply budgetary retrenchment measure to defend the currency because of the prevailing high rate of unemployment. The Bank of England did not carry out an aggressive interest rate defense. Bank rate was raised shortly before the announcement of suspension of gold standard in September 1931.

The seeds of the Bretton Woods agreement of 1944 were sown by the domestic and global economic and financial chaos of the inter-war period. After the World War II, during the decades of 1950s and the 1960s, global capital flows in the twelve sample countries[8] fell to the lowest levels recorded in Taylor's (1996) study, close to 1 percent of the national income. In 1960, the US share of global assets was 50 percent of total global foreign assets, the highest US ever held (Obstfeld and Taylor, 2002).

Although Taylor's (1996) results and those of Obstfeld and Taylor (2002) emerged from simple long-term time-series analyses, they managed to tell a telling tale. They illustrated that global financial flows were far from smooth or uniform and that they suffered frequent dislocations and serious volatility. On the one hand, there were periods when the global financial flows strengthened, like the late nineteenth early years of the twentieth century, immediately before the World War I, while on the other hand there were periods like the Great Depression when they suffered a serious loss of momentum. More complex methodology can be adopted to study the global capital flow data. For instance, a study of current account identity is possible by focusing on the relationship between domestic savings and investment trends in the selected sample countries.[9]

4. Financial Architecture After the World War II

After the World War II, most currencies were not convertible. In addition, most countries had stringent restrictions over foreign investment. Restrictions existed from both the sides, the receiving countries and the source countries. As most governments were concerned about their exchange rate stability and autonomy in monetary policy, they had to abandon free capital movement as a priority policy option. In fact, there was not much of choice making involved. Given the restrictions and currency inconvertibility, trans-border capital movements could not take place. Therefore, cross-country capital movements reached and remained at their historical low levels in the 1950s and failed to pick up during the 1960s. The Bretton Woods era (1945-71)

[8] Refer to footnote 8.
[9] To this end, several relevant studies are available. For instance, Eichengreen (1992b), Obstfeld (1995) and Taylor 1998.

of fixed but adjustable exchange rates is known for limited capital mobility and autonomy in monetary policy.[10]

Before the end of the World War II, a concerted attempt was made to reinvent a new global economic and financial order. Travails and disorder of the inter-War period demonstrated the imperious need to create such an order. Finance Ministry or Treasury officials in the allied countries turned their attention to devising an efficient and functional post-War economic order[11]. Some of the best-known scholars of this period picked up the gauntlet. This included some towering figures of the twentieth century like J.M. Keynes, who in 1941 circulated his proposal for the new international economic order. His paper was entitled *Shaping the Post-War World: The Clearing Union* and attracted a great deal of scholarly attention.

In 1942, H.D. White publicized his vision of institutions that were intended to maintain exchange rate stability, macroeconomic stability and non-discriminatory trade relations among the nations. After long debates, White's plan was accepted as the basis for the Bretton Woods agreement and the twin institutions, namely, the International Monetary Fund (IMF) and the World Bank were established, along with subsequent establishment of the General Agreement on Tariffs and Trade (GATT). As these institutions had emerged subsequent to the economic and financial chaos between the two World Wars, one of their basic premises was that both variations in exchange rates and global capital movements should be closely watched, and if need be controlled. Although this was the majority belief, there were serious dissents. Milton Friedman and Jacob Viner were among the most famous dissenters who opposed the consensus view and argued in favor of floating exchange rates and free short-term capital movements.

Countries participating in the Bretton Woods conference were attracted less by the Keynes concept of a new economic order because for all appearances it was found to be flirting with economic nationalism. His plan suffered from several excesses. It was premised on heavy governmental management of macroeconomic policies and exchange rate so that domestic stability can be attained. His proposition included extensive restrictions over foreign exchange

[10] The complete break down of the Bretton Woods system took two years between 1971-73.
[11] Four countries had prepared official plans for presentation and discussion: Canada, France, the UK and the US.

transactions in general and capital movements in particular—something reminiscent of the inter-Wars era. Exchange controls were its central feature while the notion of floating exchange rates was considered a pariah. Open capital markets had no place in his vision of the global economy of the future. Keynes also proposed an International Clearing Union (ICU) to facilitate multilateral trade among member countries. Trade deficit and surpluses of the members were to be taken care of as claims on the ICU and liabilities to the ICU, respectively. Such credits and debits were to be settled with the help of "bancor", the new international currency whose value was to be fixed in gold.

The alternative plan suggested by H.D. White accepted capital movements and viewed periodic exchange rate adjustments as something more acceptable than did Keynes. As opposed to Keynes, White's proposal favored reduced capital and exchange rate controls. However, White's plan wanted some limits placed over capital mobility because it saw US funding endless foreign imbalances in the balance of payments of the deficit countries. It proposed internationally agreed limits over capital flows for which speculators were responsible. In hindsight, White accepted the concept of global capital mobility but not without taking caution measures against excesses in capital movements (Horsefield, 1969). Thus, Keynes and White in principle wanted some kind of a rein on capital movement—putatively Keynes far more than White. Both agreed on regulation of capital flight.

While there were serious disagreements in the views of the two principal proponents, there was partial similarity in ideas on capital account. It is reflected in the Articles of Agreement of the IMF. Article VIII set out that the principal systemic objective of the IMF is non-discriminatory multilateral convertibility on current account. There were no restrains on capital movements related to current account payments. However, Article XIV allowed restrictions over capital movements during a transitional period, countervailing Article VIII. This reflected the cautiousness in the views of the two principal proponents. At the same time Article VI (3) states that, "Members may exercise such controls as are necessary to regulate international capital movements …" Article VI (1) prohibits members from using the IMF resources "to meet a large or sustained outflow of capital …" It even empowers the Fund to request imposition of capital controls in such cases. It needs to be clarified that when the IMF accepted the notion of controlling capital movement, the underlying objective was to prevent currency crises and runs on currencies. This provided autonomy to governments to manage their monetary policy. In the background of the recent crises, the provisions under these Articles of Agreements have taken on a new meaning and relevance.

Once the IMF commenced its operations, shape of things that emerged was different from what was visualized by the founding fathers. Most member countries found it difficult to adhere to Article VIII convertibility obligations. Although they were given a grace period of five years to prepare to commit to Article VIII, by 1957 only ten member countries had accepted its obligations[12]. Most other member countries were still following Byzantine foreign exchange controls. Flouting the IMF norms, some developed and developing member countries even turned to floating exchange rates. During the 1950s, Britain seriously considered switching to floating exchange rates, but after a prolonged public debate it decided against it. Britain, France, Italy, Germany did not accept their Article VIII obligations until 1961 while Japan followed suit in 1964. Germany had developed balance of payment surpluses since the early 1950s, therefore, it went a step ahead and moved to full convertibility on capital account.

Along with recovery and reconstruction, economic and financial integration endeavors were underway among the European economies during the 1950s. Six large economies on the continent of Europe were trying to form the European Economic Commission (EEC). Article 67 (1) of the Treaty of Rome (1957) called on its signatories to eliminate all restrictions on the capital movements between the member states.[13] This provision was a fundamental one because the ultimate objective of the Treaty was full financial and monetary integration and creating a single European market, which could not be achieved before this condition was squarely met. In 1959, Germany proposed and actively lobbied for complete liberalization of capital movement in the EEC member states as well as non-member states. To demonstrate the seriousness of its intent, Germany unilaterally abolished its own restrictions on capital import. In 1960, the economic and financial (ECOFIN) council of the EEC directed member countries to free the

[12] The US and Canada were among the first adhere to Article XVIII. The other eight countries were Cuba, the Dominican Republic, El Salvador, Guatemala, Haiti, Honduras, Mexico and Panama.

[13] Belgium, France, Germany, Italy, Luxembourg and the Netherlands signed the Treaty of Rome to create the European Economic Community (EEC).

capital movements of short- and medium-term trade credits, FDI and listed shares. Although these policy moves prima facie were healthy for both the European and global economies, there was an unsuspecting downside. A new era of speculative capital flows was born which bedeviled policy makers inside and outside Europe. The next logical policy moves regarding capital account liberalization were stopped in their tracks by apprehensions of speculative attacks. Italy suffered a balance of payments crisis in 1964 and Britain in 1967, which slowed the integration process.

One reason why Germany took initiative in promoting financial liberalization in the EEC was that the German economy had recorded relatively faster economic and productivity growth during the 1950s and 1960s. Together they mandated a real currency appreciation, which meant a pressure for raising prices in Germany measured in dollars vis-à-vis that of the US. This was going to be a politically unpopular move. Therefore, policy makers in Germany were not willing to accept this. However, once the German capital markets were liberalized, revaluation of the Deutsche mark was inevitable. What policy makers were reluctant to do, market forces could easily achieve.

Notwithstanding the two crises of the mid-1960s, some European economies did take liberalizing measures. As France was recording surpluses in its current and capital accounts, it unilaterally eased its controls on capital account in 1967. Student movement of 1968 sparked capital flight from France, therefore, the very next year capital controls were re-imposed in France. As Germany was the unwitting recipient of the French flight capital, it tightened its capital inflow regulations and had to impose capital controls. Speculation continued in 1969 and the Franc had to be devalued under speculative pressure. The counter balancing speculative game went on in Germany, where speculators were expecting a currency revaluation for the reasons given in the preceding paragraph. Speculative pressure on the currency revaluation was strong and mounting. In response, first the Government abandoned the official exchange rate parity and then the new Government of Willy Brandt revalued the Deutsche mark. In October 1969, it was revalued by 10 percent (Bakker, 1996).

During the decade of 1950s and 1960s, the members of the Organization for Economic Co-operation and Development (OECD) gradually became active participants in the financial globalization process. The slow growth of this process bears repeating. During these two decades the OECD countries were not only the dominant players in the global financial markets but also the few economies that participated in the global financial market place. The next group to successfully enter the global financial markets was that of the NIEs. This sub-group could be taken for being a limited market participant, whose credibility in the financial market and creditworthiness was on the rise for good reasons.

Towards the end of the 1950s, the global economy was facing the problem of dollar shortage, while growing US balance of payments deficits were causing alarm in their own right. The stock of shot-term dollar claims on the US had grown to acquire a disturbing high proportion. Some of these dollar claims were settled in gold while other were held despite mounting anxiety regarding sudden reduction in the gold content of the dollar—or an effective dollar devaluation. Conversions of dollar claims depleted US gold holdings, which at this point in time were the largest in the world. In an attempt to maintain its strength in terms of gold reserves, the US took several regulatory measures to limit the outflow of gold. Some of the major restrictive policy measures were taken after 1961, which included an escalating sequence of dividend and interest taxes, voluntary guidelines and mandatory limits (Bordo, 1993).

Although these restrictive and regulatory measures seemed rational when they were imposed, there were serious doubts regarding their effectiveness and outcome. The Eurodollar market was being created which rendered these regulatory measures completely ineffective. When dollar outflows from the US were being obstructed by regulations, the London or European subsidiaries of the US banks could easily step in to fill the gap. In addition, the European banks competed for the dollar businesses. The ultimate impact of the regulations was sending dollars into the Eurodollar markets, leading to a spectacular growth of these markets in a short time-span. The Eurodollar markets grew not only fast but also at the expense of onshore US banks. As regards the global capital movements during the late 1960s, they had increased substantially, although they involved only the industrial economies.

In the early 1970s, market perception regarding the US dollar changed. Financial markets were not impressed with the increased domestic and military spending in the US. Consequently, the dollar came under speculative pressure. Capital flows grew more volatile and set the stage for the collapse of the pegged exchange rate system. Fearing that the collapse is imminent, several industrial economies had floated their currencies before the Smithsonian agreement of December 1971. When speculators attacked the second set of Smithsonian parities of 1972, all the large industrial economies except Britain raised their barriers to capital inflows. They placed quantitative restrictions on foreign borrowings as well as taxes on interest earnings. Soon the lira and sterling pound came under selling pressure. Italy and Britain enforced restrictions on outflow of capital. However, the speculative pressures persisted. The collapse of the pegged exchange rate system came about in early 1973. By March 1973, the industrial country currencies were floating against the dollar. The five EEC currencies were jointly floating in the arrangement called "snake". The Italian lira was out of the "snake" and floating independently, while the Anglo-Irish currency union had their independent float.

Financial globalization slowed down significantly during the Bretton Woods period (1945-71). It also took place among a small number of industrial economies. Thus viewed, this was an era of slow and limited globalization. The Bretton Woods arrangement did not prove to be a viable global economic order. It failed to reconcile domestic policy objectives, pegged exchange rates, and a limited degree of capital mobility justified by an open trading system. Over the 1971-73 period, when an increasing number of industrial economies accepted "the floating exchange rate system as an open-ended interim regime", policy makers in many countries felt free to liberalize capital movements without sacrificing their domestic policy priorities.[14]

5. Financial Globalization After the Bretton Woods Failure

As set out in the preceding paragraph, during the Bretton Woods era (1945-71) only the OECD economies and to an extent the NIEs participated in the slowly developing global financial markets. Developing economies kept stringent control over their capital account throughout the Bretton Woods era. The only sources of external finance for them were the official development

[14] This section draws on Obstfeld and Taylor, 1998. For greater details, please refer to this paper.

assistance (ODA), which included official loans and grants and FDI. After the collapse of the Bretton Woods system, middle-income developing economies began to open up for greater capital mobility, while keeping an autonomous control over their monetary policy. Given the limiting conditions of the Mundellian trilemma (Refer to Section 1), fixed exchange rates could no longer be a popular policy option.

According to Mundell (2000), the contemporary era of financial globalization began with the oil shock of 1973 and the collapse of the Bretton Woods system. Both of these developments were momentous and were responsible for getting the global economy ready for financial globalization that followed. The large current account surpluses earned by the members of Organization of Petroleum Exporting Countries (OPEC) could not be invested in these countries immediately, therefore, a good part of them was recycled to developing economies through the so-called money center banks. The recycled petro-dollars went only to those developing countries that had access to capital markets. Also, a large majority of petro-dollar loans were either sovereign loans or were guaranteed by governments.

By the early 1980s, several developing economies had accumulated large debts. Many of them, particularly those in Latin America, had over borrower due to low interest rates in the 1970s. However, the 1980s began with a global downturn. Owing to weakened export revenues and historically rising interest rates, many Latin American developing countries failed to service their debt. A situation of generalized default emerged. Money center banks, which had over lent, were unable and unwilling to rollover debts that were maturing. The debt crisis of 1982 started with Mexico declaring a moratorium in July on its external liability. Flagrant defaults were avoided by concerted efforts orchestrated by the IMF. Brady Bonds were invented towards the late 1980s to resolve the debt crisis of the developing countries (Das, 1989). This development subsequently helped in the development of bond markets for the emerging market economies.

Investors in the industrial countries found that deregulation, privatization, merger and acquisitions (M&As) and advances in the information and communications technology (ICT) coalesced to make FDI and equity investment in the emerging market economies more attractive than before. It was also made easy due to growth in global financial and banking markets. The result was an FDI and equity investment spike in the emerging market economies in the 1990s. The prime movers of the contemporary wave of globalization are governments, private investing and borrowing firms, financial institutions and to a limited extent households. However, the Asian crisis of 1997 adversely affected the capital flows to the emerging market economies, although the FDI flows remained unaffected.

During the contemporary period, gradually increasing amounts of private capital flows started going to the developing economies. Private capital did not go to all the developing economies. Only a sub-group of economies, namely, emerging markets, has succeeded in attracting capital and participating in the financial globalization process. As noted below, this condition is the *sine qua non* of the emerging market economies. They are somewhat imprecisely defined as the NIEs and middle-income developing countries in which governments and corporations have access to private international capital markets, or can attract institutional portfolio investment, or both. Different institutions include slightly different sets of countries in this category. For example, the Institute of International Finance (IIF) includes 29 countries from Asia, Africa, Europe, Latin America, and the Middle East. The IMF includes all the NIEs and the middle-income developing countries in its definition of the emerging market economies. *The Economist* classifies 25 middle-income developing and transitional economies as the emerging market economies.

Domestic financial deregulation stimulated the financial globalization process. The most significant deregulation was that of capital account. Full capital account liberalization movement began in Europe during the 1980s. As noted in the Section 5, the Treaty of Rome aimed at achieving full financial and monetary integration. Encouraged by Germany, whose capital account was completely open in 1981, the members of the European Union (EU) began moving towards free intra-European capital mobility. France joined in these endeavors in 1983. The industrialized EU economies believed that a liberalized capital account would *inter alia* impose discipline over monetary and fiscal policies. The Netherlands opened its capital account completely in 1986, Denmark in 1989, Belgium, Luxemburg, and Italy in 1990, Spain, Portugal and Ireland in 1992, Greece in 1994. Although Austria, Finland, and Sweden joined the EU in 1995, their capital account was open for sometime when they joined (Bakker, 1996).

Having witnessed the recent benefits of financial globalization, policy makers and economic agents in the emerging market economies are likely to work towards a more financially integrated world and towards achieving a deeper degree of financial integration. The newest developments in the ICT and effectiveness of public policy would further underpin cross-border financial flows.

However, in spite of the progress in financial globalization, the global financial system is far from being perfectly integrated. Several counter-globalization forces are still at work. Analysts have provided evidence of inadequate progress in financial integration, imperfections in the global capital markets, persistent capital market segmentation, home country bias, and correlation between domestic savings and investment.[15] Yet, a reversal of the recent trend is difficult to visualize, albeit it is not an impossibility. It is largely because of liberalization and deregulation of economies that have taken place, as well as technological advances in the financial services sector. Besides, the channels of financial globalization are so many and so diverse that a reversal of financial globalization would be difficult. This observation applies to both partially integrated and fully integrated economies. This is not to deny that during the slack periods of global growth, the progress towards globalization would not suffer.

6. Financial Globalization and Efficiency

One of the definitions of financial globalization is integration of domestic financial system of a country with the global financial markets and institutions. The enabling framework of financial globalization essentially includes liberalization and deregulation of the domestic financial sector as well as liberalization of the capital account, without which financial globalization cannot take place. As the trans-border capital flows begin, they integrate domestic and global financial markets. In a globalized financial environment domestic lenders and borrowers participate in the global markets, and utilize global financial intermediaries for borrowing and lending.

[15] For evidence to this effect, refer to Frankel (2000), Obstfeld and Rogoff (2000), Tesar and Werner (1998) and Okina, Shirakawa, and Shiratsuka (1999).

Financial globalization has definitive and obvious efficiency implications. For instance, when capital is free to move globally, its scope widens and it tends to be attracted toward the opportunities of highest return in the global economy. To be sure, it has long-term welfare implications. Second, increased integration and globalization of financial markets is essentially based on major technological and structural developments. They have lowered the costs of transactions, information and mobility. Third, in a world of globalized finances, the recipient economies can smooth their domestic consumption and investment curves with the help of the global capital inflows. Fourth, it is well known that financial assets have variable and imperfectly correlated pay-offs. Under these circumstances financial globalization provides and enhances opportunities for investors to diversify risk by allowing them to deploy capital in a wider array of global assets. Such risk diversification also improves returns on assets, enhancing systemic efficiency.

Financial globalization exposes private agents and economies to international competition. The competitive process is regarded as one that enhances efficiency both in the goods markets and those for the factors of production. One manifestation of the enhanced international competition is the movement of capital to economies that promise highest risk-adjusted rate of return. In this kind of *mise-en-scene* there is a cost of maintaining inefficient and regulated market structures. As this kind of international competition rises, the cost to countries that maintain illiberal, regulation-ridden and inefficient financial market structures also rises.

However, there is a serious down side to global investment diversification. One lesson of the history, recent (1930s and 1980s) and remote, is that capital-importing countries often enact capital controls laws and/or prevent repatriation of yields and profits. A benign view of capital controls followed the Great Depression and it was considered acceptable, but *only* under certain conditions for certain periods.[16] As these possibilities are real, they tend to make investors cautious, on occasions overly so. Eventually the apprehension of capital controls work as disincentives to financial globalization. Such apprehensions encourage misallocation of capital by keeping excessive amount of it in capital-abundant countries, while little capital flowing into

[16] When Malaysia imposed capital controls following 1987-88 financial crisis, scholars like Paul Krugman supported the move and provided several justifications.

capital-scarce emerging market and developing economies. They also bias domestic savings towards domestic investment activity (Feldstein and Horioka, 1980).

Immobility of capital, whatever the frictional factors, can adversely affect the cross-country pattern of economic growth (See Section 8 below). For one, it will retard the convergence process among countries because capital would be confined to the capital-abundant economies. Such misallocation of capital will also have distributional implications. Inefficient allocation of capital would lead to low returns in the capital-abundant economies, while capital-scarce economies would perpetuate inefficiency of their own, which would be characterized by low wages. Such misallocation of productive resources would indeed have baneful long-term welfare implications.[17]

Another potential advantage of open capital markets, which are mandatory under financial globalization, is that policy makers realize that there is an imperious need to have a high degree of market discipline. Following a logical and pragmatic set of macroeconomic policies and toeing the line in areas like international financial regulatory and supervision norms becomes imperative policy targets. International accounting standards are known to follow financial globalization, which in turn lead to greater systemic transparency. This has both macroeconomic and institutional implications (Stiglitz, 2000). Unsound policies and poor financial regulatory environment are known to trigger quick capital outflows. This kind of cautiousness supplements the disciplining power, which is considered inherent in a commitment to an exchange rate peg. These advantages of financial globalization motivated its growth and expansion in various periods.

7. Financial Globalization and Growth Nexus

If financial globalization, as we saw in the preceding section, allocated global capital more efficiently, financial immobility naturally would yield the opposite results. It would have negative welfare implications. Economies that succeed in developing well-functioning domestic financial systems are able to do so by developing an adequate institutional base. One builds on

[17] Williamson (1996) provides a detailed and formal treatment of this issue.

the other in a symbiotic manner. Macroeconomic theory has developed enough during the last decade and has analytically established that banks and other financial institutions endogenously improve the allocation of available credit. Total factor productivity (TFP) in the economy improves through the selection and funding of projects with high private and social returns (King and Levine, 1993). Furthermore, as soon as a sound financial and institutional base is created in an economy, global investors feel confident in investing in it. They promote a higher domestic rate of investment and therefore growth, eventually leading to financial globalization of the recipient economy. Two relationships are apparent here: first, the finance-growth nexus, and second, finance-growth-financial globalization nexus.[18]

Economic history provides evidence of support to the above hypothesis. Countries that developed a sound financial system, an adequate institutional base to underpin it and were financially innovative early in their growth process, also succeeded in growing rapidly. They attracted foreign capital easily which served to bolster their growth endeavors. Three of the most conspicuous historical examples of such success are the Netherlands, Britain and the US, in that historical order. Their economic history demonstrated that they first emerged as economic leaders in their own right, followed by becoming leaders in the export of capital. The Netherlands first, and Britain thereafter, led in developing a sound financial system and institutional base in the seventeenth century. The Netherlands was the political and economic power of the seventeenth century, while Britain of the eighteenth and the nineteenth centuries. At the end of the eighteenth century, after the declaration of independence, the US developed its financial infrastructure on the same paradigm as did the two precursors. Section 6 of this paper has discussed the US financial reforms of 1790.

Following these three leaders in their tracks, during the latter half of the nineteenth century, France and Germany in Europe and Japan in Asia, also became financial innovators. Like the three leaders, these three economies also grew first into rapidly growing economies and subsequently into substantial capital exporters. Financial development and trade expansion not only underpin the growth endeavors but also help in the convergence of interest rates among the

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[18] Refer to Rousseau and Sylla (2001) and Jalilian and Kirkpatrick (2002) for a detailed discussion.

globalizing economies. Rousseau and Sylla (2001) took a sample of seventeen countries and long-term data series beginning 1850 and used well-known cross-country regression framework of Barro (1991) to study the finance-growth nexus. Their results supported the view that countries with well-developed and innovative financial systems engage in more trade and appear to be better integrated with the other economies. The seventeen sample countries demonstrated an evidence of convergence of long-term interest rates. Economic growth and increasing globalization in the Atlantic economies (named above) and Japan may indeed have been finance-led.

8. Financial Globalization and the Domestic Financial Sector

Contagion and crisis are a vexing and pernicious downside of financial globalization. That being said, global integration can indeed have a strong influence on the development of the domestic financial sector in the developing economies. Two of the most important potential economic benefits of financial globalization are development and growth of the financial sector and greater availability of funds for productive investment. Globalization is responsible for improvement in the quality of financial infrastructure in the domestic economy, which in turn reduces the omnipresent problem of asymmetric information. Lenders in a developing economy confront the problem of asymmetric information much more than in an industrial economy. This is the prime cause of adverse selection and moral hazard in the developing economies[19]. By bringing about improvement in the asymmetric information scenario, financial globalization directly cures the twin malaise of adverse selection and moral hazard. This improves not only the quality of credit in the domestic financial markets but also its availability.

Globalizing financial markets benefit both, savers (investors) and borrowers. In a financially integrated world capital movements easily and rapidly take place from where capital is to where it is needed. As alluded to earlier, investors looking for better returns on their investments seek to invest in assets in the emerging market and other developing economies where marginal return of capital is higher. That financial integration causes economy-wide benefits has been clarified in

[19] Adverse selection implies resources going to low-quality projects, and moral hazard means borrower taking risky positions after borrowing funds and use financial resources in a manner not beneficial to the lender. Adverse selection and moral hazard are the perennial problems of a poorly developed financial market.

Section 2. This kind of capital flows is reflected in the large current account deficits commonly seen in developing economies. With greater flows of capital, more capital becomes available to the economies that are well integrated with the global economy.

As more capital inflows take place with progress in financial integration, the depth and sophistication of domestic financial markets increase. Also, financial products, instruments and services expand, providing more financial opportunities to both borrowers and lenders. A larger number of instruments provide risk diversification opportunities to global lenders. Borrowers can also benefit by lowering their cost of capital. As global investors are more diversified by nature, they can consider paying higher prices for domestic bonds and equities. It was observed that with expansion of capital inflows, emerging market economies were able to develop their stock and bond markets. Their financial services industry also expanded and strengthened.

An amber signal is warranted here. Although more equity and bonds are issued now in the emerging market economies, it cannot be taken to mean that all financial institutions have improved their operations and there is an all round improvement in the domestic financial markets. Due to competition with much larger international institutions, the opposite can also occur, that is, domestic financial markets can shrink or lose their importance for the domestic borrowers and lenders. Claessens, Klingebiel and Schmukler (2001) have provided evidence of shrinking domestic stock markets in several emerging market and developing economies as trading moved on to global bourses.

The malaise of asymmetric information can be effectively controlled and minimized by bringing about improvements in the financial infrastructure. As it improves with financial globalization, it creates a transparent, competitive and efficient domestic financial system and environment for the economic agents to operate. In such an environment asymmetric information cannot grow. As financial globalization ushers in greater competition in the domestic financial market, it can generate efficiency gains. As set out in Section 2, it has been observed that financial globalization imposes stringent market discipline. By demonstration effect, international banks and other international institutions refine different areas of the domestic financial sector (for instance, accounting practices and supervision norms) and impel it towards the international frontier.

Eager to reduce their risk exposure by diversifying their portfolios and to improve their profit performance, foreign banks and financial institutions enter the emerging market and developing economies and generally have a direct impact over financial sector development in the host economy. Foreign banks also promote adoption of best practices in the domestic financial sector. They provide know-how for better risk management practices as well as corporate governance techniques. Corporate governance improves in the domestic financial sector because new global shareholders tend to monitor the management more closely. Foreign corporations bring with them state-of-the-art management techniques. When the International Finance Corporation (IFC) took a small stake in the Bank of Shanghai in the late 1990s, part foreign ownership led to significant changes in governance (Lardy, 2001).

9. Dimension of Net Capital Flows to Emerging Market Economies

Cross-country financial flows to the emerging market economies were low, at paltry $28 billion, during the mid-1970s. Net flows reached $306 billion in 1997 in real terms, at the eve of the Asian financial crisis (Schmukler and Zoido-Lobaton, 2001; Das, 2003). This was their peak level. They suffered a sharp decline after that because of the Asian and other financial and economic crises. The composition of external capital underwent a dramatic transformation during this period. Official flows or official development assistance (ODA) either stagnated or declined. As a result their relative significance in global capital flows declined. In their place, private capital flows became the major source of external finance for a good number of emerging market economies. FDI became an important and dependable source of finance for the emerging markets and other middle-income economies during the decade of the 1980s and 1990s. Its growth was particularly strong during the decade of 1990s. A large part of FDI to emerging market economies was in the form of mergers and acquisitions (M&As). Many large developing economies were privatizing their public sector enterprise during this period. Those that were rated as creditworthy by the financial markets succeeded in attracting FDI in the process (Lipsey, 1999).

While syndicated bank loans were a popular instrument during the 1970s, they gradually went out of use after the Latin American debt crisis of 1982. In the 1970s, developing countries hardly attracted portfolio investment in stocks and bond markets. They were as low as $100 million in 1970. Like the FDI, they began to increase in the 1980s. Between 1983 and 1989 net portfolio investment to the developing economies averaged $6.5 billion per annum. This average increased to $43.6 billion per annum over the 1990-94 period (IMF, 1995). Portfolio investment peaked at $103 billion in 1996 in real terms (Schmukler and Zoido-Lobaton, 2001; Das, 2003). Global institutional investors found this channel of investment functional and profitable. Mutual funds, insurance companies, and pension funds channeled large amounts through portfolio investment into the emerging market economies. In addition, a wide-ranging financial restructuring had taken place in the recipient economies making large portfolio investment possible. The Asian crisis of 1997 had a strong adverse influence over private capital flows to developing economies and they sharply declined after that.

The emerging market economies have been defined above as those where governments and corporations have access to private international capital markets, or can attract institutional portfolio investment, or both. Not all the emerging market economies have an equal access to the international capital markets. The access is directly related to their perceived creditworthiness in the global financial marketplace. Therefore, distribution of global capital among the recipient economies is highly uneven. Some economies like China, East Asian and Latin American ones have easy access and receive large amounts of global capital resources, while others like South Asian ones (India being an exception in this group) have limited access. Many like the African economies have not been able to attract any global capital.

Using *Global Development Finance* database, Schmukler and Zoido-Lobaton (2001) have shown that low-income developing economies receive very little amount of net global capital, while some does go to the middle-income developing economies. In accordance with the creditworthiness concept, lion's share of global capital flows are attracted by top twelve recipient countries[20]. All of these fall in the category of emerging market economies, which are relatively

[20] They are Argentina, Brazil, Chile, China, India, Indonesia, Korea (Republic of), Malaysia, Mexico, Russian Federation, Thailand, and Turkey.

more globalized than the others. During the 1990s global capital flows to these twelve emerging market economies accelerated at a steep rate, which affected the composition of the total global financial resources going to developing economies. The proportion of financial flows dedicated to the low- and middle-income developing economies decreased at the end of the 1990s. For all appearance, many economies in this group of rapidly financially globalizing economies are diverging from the rest of the developing economies.

10. Globalizing Financial Services

Over the decade of 1990s, presence of international financial intermediaries has expanded considerably.[21] This applies more to international commercial banks than to investment banks, insurance companies and mutual funds. It is incorrect to say that the global expansion of financial intermediaries has been uniform because this has occurred fairly unevenly. Conversely, globalization of financial services also occurs when domestic savers (or lenders) and borrowers are able to make use of financial intermediaries located globally. For instance, financial services are said to be globalized when domestic stocks are traded on large international bourses abroad. During the 1990s, presence of foreign banks increased in three regions namely East Asia, Eastern Europe and Latin America.

Foreign bank ownership of assets increased rapidly during the 1990s. Total assets held by them increase maximum in the emerging market economies in Latin America, particularly in Argentina, Brazil, Mexico, Peru, and Venezuela. In the emerging market economies in Eastern European (Czech Republic, Hungary, and Poland) share of total assets controlled by foreign banks crossed 50 percent of the total. As compared to these two regions, the activities of the foreign banks expanded less rapidly in the emerging markets of East Asia, like Korea (Republic of), Malaysia, and Thailand. (Schmukler and Zoido-Lobaton, 2001)

International bond issuance activity by emerging market economies recorded a sharp spurt in 1993, crossing $50 billion for the first time. It stabilized around this level until 1996 when it

[21] This section is based and draws on Schmukler and Zoido-Lobaton, 2001 and Das 2003. The statistical data used here comes from the same sources.

nearly doubled. Both 1993 and 1996 were the years of high global capital flows. In 1997, issuance activity by emerging market economies peaked at $120 billion. Due to Asian financial crisis and its contagion effects, international bond issuance dropped to around $75 billion over the next three years. (Schmukler and Zoido-Lobaton, 2001)

The ADRs and GDRs are negotiable certificates representing ownership of shares in a corporation in another country. They are held by a depository, which in turn issues a certificate that can be traded in another country, for example, the United States. Emerging market economies began using ADRs and GDRs for raising capital from the global capital markets in 1990 in a small way. The middle-income developing countries began using them in 1992. Firms from both emerging market and middle-income developing economies increased their participation in the US equity markets using ADRs and GDRs. The top six emerging market economies that had the highest participation over the decade of the 1990s were: Argentina, Brazil, China, India, Korea (Republic of) and Mexico. They accounted for most of the activity by developing countries in the US equity markets. In terms of capital flows, this group may be creating a divergence among the developing countries. This group benefits more from the global capital markets by way of lower cost of capital and longer maturity structure of its debt. (Schmukler and Zoido-Lobaton, 2001)

11. Conclusions and Summing-Up

The evolution of global financial integration was not a record of ever-more-perfectly-functioning markets with ever-lower transaction costs and ever expanding scope. Long-term growth of global financial markets was far from linear. Vicissitudes in the volume of financial flows were more common than uncommon. Neither the concept nor the phenomenon of financial globalization can be considered novel. Cross-country capital movements have a long and well- documented history. Some of the earliest international banks among them were born in Venice. The Medici family of Venice was among the first wealthy families to successfully venture into international banking in a big way during the Renaissance period. From Italy, international banking expanded to the northern port cities of Bruges and Antwerp, and then to Amsterdam and London, essentially in that order. As economic activity expanded to the so-called New World offshoots of

Western Europe, international financial transactions supported it and international financial centers developed in those parts of the New World. Using different measures and indicators, several analysts tried to establish that a greater degree of financial globalization existed in the previous epochs of globalization than in the contemporary period.

After the World War II, as most governments were concerned about their exchange rate and autonomy in monetary policy, they had to abandon free capital movement as a priority policy option. Cross-country capital movements reached their historical low level in the 1950s and failed to pick up during the 1960s. Before the end of the World War II, a concerted attempt was made to reinvent a new global economic and financial order. While there were serious disagreements in the views of the two principal proponents, namely J.M. Keynes and H.D. White, there was partial similarity in ideas on capital account. It is reflected in the Articles of Agreement of the IMF. Along with recovery and reconstruction, economic and financial integration endeavors were underway among the European economies during the 1950s. Six large economies on the continent of Europe were trying to form the European Economic Commission (EEC). Article 67 (1) of the Treaty of Rome (1957) called on its signatories to eliminate all restrictions on the capital movements between the member states. Germany took a good deal of initiative in promoting financial liberalization in the EEC was that the German economy had recorded relatively faster economic and productivity growth during the 1950s and 1960s. During the decade of 1950s and 1960s, the members of the Organization for Economic Co-operation and Development (OECD) gradually became active participants in the financial globalization process. The Bretton Woods period (1945-71) is known for slow and limited financial globalization. The Bretton Woods arrangement did not prove to be a viable global economic order. It failed to reconcile domestic policy objectives, pegged exchange rates, and a limited degree of capital mobility justified by an open trading system.

Developing economies kept stringent control over their capital account throughout the Bretton Woods era. The only sources of external finance for them were the official development assistance (ODA), which included official loans and grants and FDI. After the collapse of the Bretton Woods system, middle-income developing economies began to open up for greater capital mobility, while keeping an autonomous control over their monetary policy. Given the limiting conditions of the Mundellian trilemma, fixed exchange rates could no longer be a popular policy option for them. Awareness of benefits from financial globalization grew among the developing economies. Having witnessed the recent benefits of financial globalization, policy makers and economic agents in the emerging market economies began to work towards a more financially integrated world and towards achieving a deeper degree of financial integration. The newest developments in the ICT and effectiveness of public policy would further underpin cross-border financial flows. During the contemporary period, gradually increasing amounts of private capital flows started going to the developing economies.

Financial globalization has definitive and obvious efficiency implications. For instance, when capital is free to move globally, its scope widens and it tends to be attracted toward the opportunities of highest return in the global economy. To be sure, it has long-term welfare implications. Contagion and crisis are a vexing and pernicious downside of financial globalization.

Cross-country financial flows to the emerging market economies were low, at paltry $28 billion, during the mid-1970s. Net flows reached $306 billion in 1997 in real terms, at the eve of the Asian financial crisis. This was their peak level. They suffered a sharp decline after that because of the Asian and other financial and economic crises. Over the decade of 1990s, presence of international financial intermediaries has expanded considerably. This applies more to international commercial banks than to investment banks, insurance companies and mutual funds. It is incorrect to say that the global expansion of financial intermediaries has been uniform because this has occurred fairly unevenly.

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