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**FINANCIAL GLOBALISATION AND THE SHIFTING SANDS
OF CONTEMPORARY FINANCIAL MARKETS**

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Abstract

The objective of this article is to examine the evolution of the global financial markets during the post-World War-II era, when they were in a moribund state. In 1973 quadrupling of oil-prices occurred, which proved to be a seismic economic event that affected the global economy and financial markets. Around this period, a good number of lower- and upper-middle income developing economies broke from their tradition of following erroneous and unproductive economic strategies. They committed to improving the macroeconomic and financial climate in their economies by carrying out macroeconomic reforms and restructuring of their economies. The collapse of the Bretton Woods regime was a defining moment for the world of global finance. It was followed by a notable surge in cross-border capital flows from the private global capital markets. With the largest industrial economies of the world abandoning the concept of capital control and with an increasing amount of financial activity taking place in the Eurodollar markets, other countries had little choice but to open their financial sectors as well. Developing economies could not remain impervious to the on-going transformations in the financial markets of the advanced industrial economies and the global financial markets for long. Their domestic financial and capital markets reacted to the forces of change in the advanced industrial countries as well as to the ongoing financial globalization and innovation.

While financial globalization during the preceding three decades proliferated broadly, it did not proliferate evenly across the globe. There was a marked difference in the extent of integration around the globe. Neither all regions integrated financially uniformly, nor all financial crises had comparable impact over financial integration of different economies. Due to the negative impact of the crises of 1997 and 1998 over the global private capital markets and investor confidence, global investors began considering the developing economies to be unsafe for investment.

Over the past three decades *de facto* financial globalization has increased in most countries, but integration has moved furthest in the OECD countries, where it has primarily taken the form of two-way (diversification) asset trade, with large gross holdings of external assets and liabilities, but relatively small net external positions.

~ International Monetary Fund (2008a, p.4)

1. Introduction

Modern history of financial globalization can be traced back to the Renaissance, when Italian banks financed trade and governments in Europe and around the Mediterranean. The Medici family of Venice was among the wealthiest in Europe.¹ It was among the first to venture successfully into international banking. Italian banks developed instruments to methodically finance trade. The Medici bank was one of the most prosperous and respected European financial institutions of this period. Although this could be regarded as the precursor of financial globalization, its geographical scope was limited. As European trade expanded, financial innovations spread northward through the letters of credit. They were invented at the Champagne Fair in France and became a widely-accepted financial instrument (Obstfeld and Taylor, 2005). International banking spread north from Italy. Banks in northern ports like Bruges and Antwerp also used financial instruments developed by the Italian banks as well as the letters of credit. Amsterdam and London were next to develop as hubs of international finance, with their currencies playing key international roles.² Financial instruments developed and used in these two centers were considered credible and valuable by the market players of this period.

This article essentially traces the financial globalization in the contemporary period. In so doing, it begins with the impact of several momentous developments in the post-World War-II era, which helped shape the contours of the contemporary era of financial globalization. It traces the emergence of the financial and capital markets in the post-World War-II era and delineates the shifting trends during the post-2000 period. Thus, it covers the global financial canvas of a large chronological span.

This article gets underway by tracing a widely acknowledged fact that global economic and financial integration can and did go into a reverse gear. Following a breakdown during the inter-War period, the global financial system and capital markets began their reconstruction and rejuvenation task in the post-World War II period. The reconstruction efforts of the immediate post-World War II era are the first focus of this article. During the decades immediately after the World War-II, particularly in 1973, several developments took place that had momentous global economic and financial implications. They made a contribution to the rejuvenation of the international financial architecture and global capital markets. Also, at this juncture in a small group of the advanced industrial economies, a spurt in global capital market flows occurred. A large global market for cross-border syndicated loans developed in the post-1973 period. This market had a wide geographical spread.

¹Lorenzo de Medici took Michelangelo Buonarroti under his wings when Michelangelo was still a little boy and provided the right artistic ambiance to him to nurture and hone his genius.

² For the birth and expansion of international banking and finance and a detailed historical account of international capital flows see Cameron (1993), Das (1986) and Neal (1990).

Adoption of macroeconomic reforms and restructuring and dismantling controls and restrictions were the preconditions of financial globalization. Other than these, adoption of privatization and ushering in the necessary innovations in their financial markets were the other strategies which could help. Several factors like liberalization and deregulation adopted by the advanced industrial economies and emergence of a strong institutional and retail demand for financial assets supported the onward march of financial globalization. As elaborated at length in this article, spurred by deregulation and financial innovation securities markets in the advanced industrial economies also began to develop much faster than ever in the past. Consequently rapid transformations in the global financial landscape began to take place. The preceding two decades were of particular significance in this regard. The pace of financial globalization has accelerated. Over these decades the rate of increase of global cross-border investment was twice that of rate of growth of multilateral trade in goods and services, which in turn exceeded at the rate of global GDP growth (Lane and Milesi-Ferretti, 2007). Also, the average daily turnover of the foreign exchange market more than doubled in one decade. It was \$1.5 trillion in April 1998 but increased to \$3.2 trillion in 2007 (BIS, 2007).

The advanced industrial economies were the first to financially globalize, while the emerging-market economies (EMEs) and the other large developing economies followed suit. They were influenced by the structural changes that were occurring in the financial and capital markets in advanced industrial economies and began to unilaterally liberalize and restructure their macroeconomic policy framework and usher in identical policy transformations in their financial sector. The growth of financial globalization picked up momentum. Rapid progress in financial globalization turned the decade of the 1990s into one of unparalleled boom. In particular, the mid-1990s are regarded as an invigorating period of growth and financial globalization.

International financial integration during the contemporary period is of substantially higher intensity than that in the past. Gross world assets divided by global GDP is a good measure of capital market integration. Its volume is roughly 100 percent of the global GDP at present, compared to approximately 20 percent in 1913, the last year of the previous era of financial globalization (Schularick, 2006). Similar numbers were computed by Obstfeld and Taylor (2004). This increase in the global financial integration is largely due to much closer financial ties between the advanced industrial economies. The present period of financial globalization was characterized as a "rich-rich affair" (Obstfeld and Taylor, 2003, p. 254). Although financial globalization progressed with increasing market capitalization and liquidity in a small number of large financial centers, its idiosyncratic feature was that financial activity was essentially concentrated in the large financial centers of the advanced industrial economies, namely, Germany, Japan, the United Kingdom (UK) and the US. Financial markets in Frankfurt, London, New York and Tokyo overwhelmingly dominated global financial market activity. This period of rapid progress of financial globalization was interrupted by the fallout from some serious crises. The Asian financial crisis (1997-98) unfavorably affected it. The Asian crisis was followed by the Russian or Ruble crisis (1998), which had its normal impact over global investors' psychology. Although the interruption caused by these crises and the bursting of the information technology (IT) bubble was acute, the world economy continued to grow more integrated in terms of accelerated movements of goods, services and capital, which made the 1990s and 2000s more momentous than the preceding decade (Das, 2009a).

Ensuing the Asian and Russian financial crises, global capital flows to the developing economies dwindled and commodity markets went into a sharp decline. Notwithstanding the 1997-98 financial crises, financial flows and integration among the advanced industrial economies continued to surge at an even pace. They were uninfluenced by the meltdown of 1998. A much broader global impact was made by the end of the so-called IT boom, or bursting of the dot-com bubble, in early 2001. The advanced industrial economies and their financial markets were adversely affected by the short recession caused by it. Notwithstanding this blip, between 1995 and 2006 global capital flows soared from 6 percent of the world GDP to 14.8 percent. In 2008, their value was \$7.2 trillion, more than triple their value in 1995 (IMF, 2008b).

Although a major part of this increase in the global capital flows took place in the advanced industrial economies, the developing economies did not remain rank outsiders. Many of them participated fairly actively. Debt and equity finances to the developing countries increased during the 1990s and the post-2000 period. This increase was far from monotonic. Cross-border syndicated bank lending to developing countries, international bond market flows and those in the form of equity (foreign direct investment and equity) investment soared dramatically after 2004. The sub-prime crisis led global financial turbulence that began in the autumn of 2007 did not affect these financial flows to the developing economies adversely. Although proliferation of financial globalization was far from uniform in the global economy, rapid advances in financial globalization began progressively changing the nature of capitalism in the world economy.

2. Drivers of Financial Globalization in the Contemporary Era

What factors were, and can be, responsible for the rapidity of financial integration is a valid query. As elucidated above, the ICT which is an enabling technology, played crucial role in advancing financial globalization. Recent advances in the ICT shrank the globe and made national boundaries less significant. What is more relevant for the purpose of financial globalization is that they proved to be a resilient and momentous driver of financial globalization. They played a key role in advancing financial innovation in the capital markets. They facilitated efficient transmission of financial information as well as caused sharp decline in costs of communications as well as transaction costs, which in turn proved to be a veritable stimulus to financial globalization. Advances in ICT and computer-based technologies increased computing power of financial institutions and individuals alike. They facilitated collection and processing of financial information for the market participants and monetary and regulatory authorities. They made it possible to measure, monitor and manage financial risk for the market participants. Without computers pricing and trading of complex new financial instruments was not feasible. Managing large and rapid transactions, and then managing books for these transactions, which are usually spread across continents, could not be accomplished without the support of ICT. The overall impact of ICT was a dramatic expansion of cross-border financial flows.

In the advanced industrial economies, recent growth in financial globalization was primarily stimulated by early waves of liberalization of capital account and financial deregulation. Recent cross-border financial integration in this group of economies was *a fortiori* driven by the rapid pace of financial innovation. Sectoral developments like securitization, rise in the activities of hedge funds and increased use of offshore special purpose vehicles by financial and non-financial corporation has also led to rapid growth in cross-border financial holdings among advanced industrial economies.

The influence of rapid financial innovation on financial globalization in this group of economies has been greater than generally visualized. It was observed in the recent years that financial innovation in one advanced industrial economy raised demand by foreign investors in the other. These investors rationally wished to access and profit from the new asset class that has just come into being.

Pattern of merchandise trade is another consequential variable in this context. As stated below cross-country FDI and portfolio equities flows are driven by the underlying patterns of merchandise trade between the investing and the recipient countries. It is possible that the level of trade may be a proxy for bilateral information flows. The other factors that influence cross-country investment flows are the linkages by way of common language and common legal systems are also influential factors. In addition, the impact of recent emergence of a highly successful group of exporting economies on the contemporary financial globalization was enormous. This group includes both exporters of manufacturers and services as well as commodities. The four BRIC economies and East Asian economies come under the first category, while the GCC countries come under the second.

Hedge funds and private equity firms are the other active groups having a growing impact on the global financial markets. They have been termed “the new power brokers” by McKinsey Global Institute (MGI, 2008; p. 5). Emergence of these four institutions in the global financial markets represents dispersion of financial power away from the traditional institutions in the advanced industrial economies. The financial clout has been getting diffused towards the new players and other parts of the world than the advanced industrial economies. The wealth and influence of the new power brokers has grown in the recent years. According to the estimates made by the MGI (2008 and 2009), the combined financial assets of the Asian central banks, GCC, hedge funds and private equity firms were \$11.5 trillion in 2007 and \$12 trillion at the end of 2008.

The first half of 2008 was not very bad for the Asian economies, whose current account surpluses persisted. Petro-profits of the members of the GCC also continued to grow. The sub-prime mortgage crisis led global financial turbulence that began in the autumn of 2007 initially did not affect the private equity firms very much. They survived the turbulence in a reasonably good shape. Conversely, hedge funds were hit hard since the beginning of the global financial. There is no denying that the financial crisis and recession abruptly halted the power brokers’ rapid ascent. In 2008, both hedge funds and private equity firms were hit hard when credit markets were seized up, depriving them of the leverage that amplified their influence in the global financial markets. They were further battered by the decline in global equities, which erased much of their investors’ wealth. In 2009 both of these industries had grown smaller and were shrinking. Their future will be different from their past. They will need to adapt to the new climate of tight credit and stringent regulation (MGI, 2009).

Financial globalization can be potentially driven by the financial development in the domestic economy. As the depth of the domestic financial system increases, it tends to become increasingly globalized. The GCC economies are a case in point. There can be a direct link between financial development and financial globalization. Also, the development of the domestic sector can be promoted by foreign investment and entry of foreign banks. Yet another relevant variable is the level of economic development in the domestic economy. Better developed economies generally make a concerted drive

towards financial globalization. The level of economic development influences the propensity of the domestic economic agents to engage in cross-border asset trade. Higher international financial integration is commonly seen in well-off economies. Switzerland, one of the highest-income economies in the industrial world, has also been a long-standing prosperous and efficient center of trade in global financial assets.

3. Transformations in Global Financial Landscape

The collapse of the Bretton Woods regime was a momentous event for the world of global finance. It was followed by a surge in capital flows from the private global capital markets. With the largest industrial economies of the world abandoning the concept of capital control and with an increasing amount of financial activity taking place in the Eurodollar markets, other countries had little choice but to open their financial sectors as well. The 1973 quadrupling of oil-prices affected the global financial markets in a significant manner. It had both an immediate and long-term impact. Driven by the gush of liquidity from the OPEC countries, impressive systemic growth in the financial and capital markets began. By the mid-1980s, majority of the advanced industrialized economies were open to cross-border capital flows.

A large amount of financial capital accumulated in the OPEC economies, which could not invest them domestically in the short-term. Increased financial intermediation of these resources began first through financial institutions and then through the securities markets. Their operations expanded at a remarkable pace. The depth in the financial markets of the advanced industrial economies increased sharply since this time point. Participation of the countries in the global financial markets also expanded beyond the high-income industrial economies. The range of financial services and financial instruments *pari passu* expanded enormously to reach new unprecedented dimensions. For the private global financial markets, these developments marked the initiation of a period of major structural and qualitative transformation. They not only kicked off but also catalyzed the contemporary globalization of financial and capital markets.

After a good deal of experimentation, the Brady initiative was launched in the late 1980s. It was a significant objective; its express purpose was to resolve the Mexican debt crisis. It facilitated the process of bringing in the developing economies of Latin America back into the fold of the global financial markets. It was named after Nicholas Brady, the US treasury secretary. Under this plan the distressed or non-performing bank loans were repackaged into the so-called Brady bonds. The Brady plan allowed the debt ridden economies to restructure their debt by converting existing bank loans into collateralized bonds at a significant discount, or at below market interest rates. The principal was collateralized by the US treasury in 1989. They were 30-year zero-coupon bonds purchased by the debtor country using financial resources from the IMF, the World Bank and the foreign exchange reserves of the purchasing country. The Brady bonds innovated under this plan were more liquid and therefore more tradable. This innovation allowed commercial banks to exchange their claims on the indebted developing economies of Latin America for tradable instruments. This measure helped them eliminate large debt volumes, or impaired assets, from their balance sheets. These dollar denominated bonds were traded on the international bond markets (Das, 1989).

One of the immediate consequences of the creation of Brady bond market was creation of a deep market for sovereign bonds in a short time span. It proved to be a

thoughtful and successful initiative, resulting in gradual return of investor confidence in the developing countries. The Brady initiative had the desired impact of clearing the way for the crisis-affected developing countries of Latin America to re-enter the booming international capital markets. It influenced the private global financial markets and their operation during the decade of the 1990s and proved to be a strong impetus to them.

3.1 Dawn of the Cross-Border Syndicated Bank Loan Market

Among the different genre of financial markets, the syndicated loan market was the first international financial market to develop. These loans were recycled petrodollars of the OPEC countries. The large post-1973 surpluses of the OPEC countries were channeled through the Eurodollar markets to the developing countries of Africa, Asia, Middle East and particularly to Latin America. An immediate consequence of this development was that the financial markets in the advanced industrial economies developed, deepened and in the process transformed dramatically. The developing economies of Latin America emerged as large borrowers of syndicated loans during the 1970s. These loans were made by the money center banks of the large industrial economies in the European Union (EU), Japan and the US.

The syndicated lending expanded at a rapid pace, peaking in 1982 at \$57 billion. Mexico defaulted on its sovereign loans in August 1982, setting off the Latin American debt crisis. This crisis revealed that the Latin American economies had over-borrowed and the money center banks over-lent. The ensuing financial crisis was a major one and drove the global financial markets to the brink of a veritable debacle. In the early stage this crisis was designated as a liquidity issue, which could be resolved easily with the passage of time. However, eventually it was realized that there was a question mark over sovereign solvency of the borrowing countries. Protracted endeavors were needed in terms of internationally agreed-upon debt-reduction protocol. Syndicated lending to the Latin American economies came to an abrupt halt. For good reasons, these and many other developing economies were ostracized from the global financial markets. Their participation could not be revived until the late 1980s.

In the mid-1980s, European economies began their journey towards formation of the economic and monetary union (EMU). They liberalized their financial markets and began participating increasingly in the global bonds and equity markets. The capital raised by them increase from paltry \$6 billion in 1980 to \$72 billion in 1989. This contributed to further globalization of the financial markets (Lane and Milesi-Ferretti, 2008a).

3.2 Contribution of Brady Bonds to Financial Integration and Globalization

The Brady bond initiative helped restore investor confidence in the developing economies. Soon the developing country governments began issuing debt outside the Brady market. This mitigated the negative impact of the Latin American debt crisis and financial globalization once again began to flourish. The Brady bonds turned out to be a catalyst for the development of the EMEs bond markets in the 1990s. Private firms from the large developing economies followed their governments and began raising capital in the global bond markets. Bond issuance activity soon picked up momentum and EME bond issuance began to rise. In stages, demand for developing country bonds began to rise in the global capital markets. The developing countries of Latin America, which were being ignored by the global capital markets, benefited particularly from the international bond issuance. Their bond issuance soared from \$1.5 billion in

1990 to \$58 billion in 1997. The compelling trend in global financial integration during the 1990s was provided an impetus by lifting of capital account restrictions in many countries. Other barriers to overseas investment were also dismantled. The level of activity in global financial markets picked up markedly during this period, which in turn enhanced global financial integration.

In 1990 the EMEs issuance was mere \$4 billion, but before the Asian crisis in 1997 it reached \$99 billion. The Asian and Russian crises understandably dampened down issuance activity. However, it soon recovered and reached \$183 billion in 2005. From decade to decade, there was a continual rise in the volume of capital flows to the developing economies. It was far higher in the 1990s compared to the 1980s. In constant (2000) dollars, they peaked at \$158 billion in the 1980s, as against \$353 billion in the 1990s. After a crisis-driven decline in 1997, capital flows to the developing economies picked up again to reach a new peak in 2004 at \$379 billion (de la Torre and Schmukler, 2007).

Easing of market sentiment by the Brady initiative in the global capital markets provided incentive to the syndicated loans market as well. As the monetary conditions in the early 1990s in advanced industrial economies were relaxed, syndicated lending to the developing economies rose at a brisk pace. It peaked in 1997 at \$190 billion, which was close to four times its level in the early 1980s. One major difference from the early 1980s was that during the 1990s the largest beneficiary country group was not the economies of Latin America but those in Asia. Their borrowings added up to almost \$100 billion in 1997. The nationality of lending banks also changed. In the early 1980s, syndicated lending was dominated by the US banks. As opposed to this, during the decade of 1990s, the European and Japanese banks led global syndicated lending business. During the boom of the 1990s, large business corporations from the advanced industrial economies emerged as the other large borrowing entity. By 2004, global syndicated bank lending touched \$2.5 trillion. Major part of these financial resources, \$1.8 trillion, went to the advanced industrial economies (Cipriani and Kaminsky, 2006).

One remarkable development in the arena of global finance during the 1990s was accelerated growth of international equity market. They experienced a boom during this decade. Business corporations around the world not only started raising capital from the unregulated international bond and syndicated loan markets but also began participating in the regulated equity markets in the large and liquid financial centers. Most notable in this regard was the highly liquid US capital market which began attracting global equity issuers as well as investors in the early 1990s. Instruments like the American Depositary Receipts (ADRs) facilitated global issuers' task of raising capital on the US stock market. In place of foreign stocks ADRs were traded on the US stock market with ease. Likewise, other important stock markets around the world also attracted global issuers. As global financial integration progressed, business firms around the globe were able to simultaneously issue equity underwritten and distributed in multiple foreign equity markets as well as in their domestic markets. This was termed the Euroequity market. Generally an international syndicate issued Euroequity, which entailed an initial public offering (IPO) occurring simultaneously on more than one national stock market.

With increase in volume of capital flows to the developing economies, a great deal of transformation took place in the composition of capital flows. In this regard, the 1990s

were an era of demarcation. During the pre-1990s, external capital flows to the developing economies predominantly comprised the official development assistance (ODA) and syndicated lending by the commercial banks. During the post-1990s, this structure of capital flows changed due to *inter alia* a sharp decline in the ODA. Loans from commercial banks were supplanted by capital raised in the global stock and bond markets. Also, FDI in the developing economies increased during the latter period. FDI expansion was partly stimulated by large scale privatization in many large- and middle-income developing countries. Since the early and mid-2000s, the shift towards FDI and equity-related capital flows strengthened further. Popularity of Euroequity increased and the EMEs in Asia and Latin America began attracting increasing amounts of global capital in the form of equity investment.

A high degree of concentration in global private capital flows to developing economies and instability are two of the negative characteristics of contemporary financial globalization. No doubt the recent wave of financial globalization has accelerated flows of private global capital to the developing economies, it does not go to all the developing economies. Not all of them have access to global capital markets. In addition, the distribution of private global capital demonstrates extreme unevenness. The 10 largest recipients of private capital siphon off more than 65 percent of the total. The next significant group of recipient is the middle-income developing countries. Unlike these two country groups, the low-income ones are at the other extreme. They receive only marginal amounts, if any. Besides, a high degree of instability in these flows was caused due to impulsive and unexpected shifts in investor sentiments towards the EMEs. The Asian and Russian crises demonstrated that sudden stoppage or reversal in global capital flows were real threats. Their macroeconomic implications were painful for the recipient economies.

3.3 Financial Integration and the Developing Economies

The advanced industrial economies and their financial markets took lead and forged the way forward in the arena of financial globalization. They were and continue to be the principal players in this arena. Although not directly involved, developing economies could not remain impervious to the transformations in the financial markets of the advanced industrial economies and the global financial markets for long. In a rapidly globalizing world economy, external economic and financial environment changed profoundly. Their domestic financial and capital markets reacted to the forces of change in the industrial countries as well as to the ongoing financial globalization and innovation. These forces had a demonstration and learning effect over the developing economies. They decisively influenced and shaped the financial markets in the developing countries. Many of the developing economies unilaterally pursued extensive reform agenda to harmonize with the changes and advancements in the capital markets of the advanced industrial economies. Consequently after some time capital markets in many developing economies, albeit small, began to look similar to those in the advanced industrial economies.

The steady growth of global financial markets enhanced global financial integration as well as led to boom conditions in the 1990s. This was a defining moment and reshaped the global financial landscape. At this juncture, the pace of financial intermediation expanded at a remarkable pace. It is clearly exemplified by the cross-border flows of gross financial assets and liability. At the end of the decade of the 1990s, sum of cross-border financial assets and liabilities (in gross terms) exceeded the nominal GDP of the advanced industrial economies by 200 percent. During the 1980s, the

corresponding figure was equal to the GDP of this country group (de la Torre and Schmukler, 2007). This is a convincing proof of vigorous expansion of the global cross-border financial flows. Similarly, Cipriani and Kaminsky (2006) reported an explosive increase in the international bond, equity and syndicated loan markets. While the international bond and equity markets recorded a 100-fold increase in gross issuance between 1984 and 2004, the syndicated loan markets increased 30 times over the same period. The total amount raised by firms in securities markets outside their home countries has grown more than four-fold since 1990; it reached \$1 trillion in 2005 (Gozzi, *et al* 2008). Increasing global financial integration has essentially altered the framework for interpreting and responding to major economic events (Greenspan, 2007).

Both financial institutions and securities markets participated in the global financial intermediation operations. The high-income industrial countries led the financial globalization. According to one estimate, the financial markets in the Group-of-Seven (G-7) countries were so active that the sum of credit from the banks, stock market capitalization and private bonds outstanding averaged 260 percent of the GDP in 2004. In 1975 the corresponding figure was 100 percent (de la Torre and Schmukler, 2007). These statistics speak for the exhilarating rate of expansion of the global financial markets and their rapidly growing integration.

Statistical data series on capital flows and investment positions for individual economies are not easily available. The financial flow data for the large developing economies are available for the 1980s and thereafter. The IMF began to compile more comprehensive data on investment positions of individual countries since 1997. The data available for the advanced industrial economies indicate, what was stated in the preceding paragraph, an unmistakable slant in global financial integration during the contemporary period. It essentially takes the form of asset swapping among the economies of the advanced industrial economies. As opposed to this, asset swapping between the advanced industrial economies and the developing ones was relatively much smaller (Lane and Milesi-Ferretti, 2003; Obstfeld and Taylor, 2004; Obstfeld, 2007).

The principal factors driving the strong performance of securities markets in the main financial centers in advanced industrial economies were: First, financial liberalization and deregulation progressed at a steady pace in the advanced industrial countries. Secondly, in the financial markets, pioneering technological and financial innovation took place during these decades. Thirdly, a large dedicated investor base developed and grew rapidly in the high-income industrial economies. This included both institutional and retail investors. These were important developments. The developing economies watched these developments, learned these practices and after a time lag implemented them in their own economies. These factors coalesced to have an enormous effect over financial globalization and the integration of a group of dynamic developing economies into global financial markets.

3.4 Transformation in the Financial Markets of the Developing Countries

How and to what extent the developing countries brought about changes in their financial markets is a valid query. Most developing economies had traditionally adhered to strict capital controls. The Bretton Woods period reinforced and lengthened that tradition. Stringent controls were continued in the EMEs, both domestically and on international transactions. As elaborated above, the course of

financial globalization and progress that occurred over the preceding few decades in the advanced industrial economies had an influence on the developing economies. They swayed the financial sector and capital market development in this group of economies. These developments generated an ambiance and inclination for much-needed transformation in their capital markets.

In addition, the developing countries had nurtured a tradition of banking sector dominating their financial sector for a long period. Until the early 1990s domestic financial markets in the developing economies were dominated by the banking sector. Diminutive securities markets were their long-standing weakness. In many of them securities markets were nonexistent. Government intervention in the financial sector was almost omnipresent. In many developing countries government controls were excessive, so much so that market forces had little role left to play. Governments regulated both interest rates and credit disbursement by banks. Financial repression was rampant. The direction of bank credit flows were often maneuvered by the ministries of finance in these countries. Government interventions in the operations of financial institutions were endemic. The central banks played an energetic role in influencing the operations of the domestic banks. In many of them, the largest banks were in the public sector. This state of affairs began to change in the early 1990s.

3.5 Financial Deepening in the Contemporary Period

The contemporary period of financial globalization is different from that around the turn of the 20th century, which was overwhelmingly dominated by a select group of economies, namely, the Western European economies and the so-called economies of the New World. The low-income developing economies of that era played a peripheral role. Conversely, in the present era, capital mobility was far more broad based in terms of the economies involved and the financial instruments used. The current phase of financial globalization entailed the participation of a good number of developing economies.

Recent decades saw a striking transformation in the global financial system. As the costs of gathering and processing information fell, as sophisticated modeling techniques came into use in finance and competitive pressure intensified, more and more economies began to move away from traditional bank-based system of financial intermediation to a more market-based system. Rapid growth of the financial market was the natural consequence. The growth rate of financial markets has been much faster than that of the global GDP. Consequently, financial depth, which is measured as the ratio of a country's financial assets to GDP, has been steadily rising. It has happened not only in individual countries but also in all the regions of the global economy.

As financial markets grow deeper they come to have greater liquidity and entrepreneurs directly benefit from it. Another direct benefit of a deeper financial market is that it prices assets more efficiently and provides more opportunities to spread risk. That individual financial markets are far deeper at present and many more countries have deeper financial markets is proved by the following statistics. In 1990 only 33 countries had financial assets having larger value than their respective GDPs. By 2006, this number more than doubled to 72. The four BRIC economies, namely, Brazil, the Russian Federation, India and China stand out as countries with financial assets far larger than their GDPs. In 1990, only two countries had financial depth exceeding 300 percent. This number at present is 26 (Farrell, *et al*, 2008).

Increasing depth and advances in financial globalization favorably affected capital flows to the developing economies, in particular to the EMEs, in two distinct manners: First, volume and composition of the capital flows to them were evidently influenced. Secondly, financial services were progressively internationalized, which favorably affected the capital flows to the developing economies. As financial globalization progressed, liquidity in international capital markets increased, which resulted in growth in capital flows to the EMEs. Increasing expansion in trans-border capital flows during the current century completely eroded the boundaries that existed between the national capital markets during the early post-World War II era. A single global capital market gradually emerged (Crockett, 2009).

3.6 Impact of Financial Crises and Setbacks

This period of rapid progress of financial globalization was interrupted by the fallout from some serious crises. The Asian financial crisis (1997-98) unfavorably affected it. Although several economy-specific crises, like the Tequila crisis of 1994, had occurred in the interim, the Asian crisis was the first major setback to the global economy since the Latin American debt crisis of 1982. The Asian crisis not only mangled the so-called miracle economies of Asia but also the regional economy and affected the global capital and stock markets adversely. It was intensively analyzed by the economic profession and a large crisis-related analytical literature came into being. One tangible result of this research was the development of policy tools to comprehend and manage such financial and currency crises.³

During this period, many developing economies, particularly the EMEs, were still on one kind of fixed exchange rate regime or the other. That these economies were fragile was brought home by the Asian crisis. As opposed to them, some of the large EMEs, like Brazil, Chile and Mexico, had switched to exchange rate flexibility coupled with inflation targeting. The continuing economic and financial globalization picked up a good deal of momentum during the mid-1990s. The Asian crisis was followed by the Russian or Ruble crisis (1998), which had its normal impact over global investors' psychology. Ensuing these two crises, global capital flows to the developing economies dwindled and commodity markets went into a sharp decline. This was followed by the end of the so-called ICT boom, or bursting of the dot-com bubble, in early 2001.

Notwithstanding the 1997-98 financial crises, financial flows and integration among the advanced industrial economies continued to surge at an even pace. They were uninfluenced by the meltdown of 1998. The large current account deficits of the US continued to be financed by the industrial and developing countries that were running surpluses. This implies that divergent trends in financial integration among the industrial and the developing economies materialized. While the former were integrating at a progressive rate, the latter group of economies was lagging. A strong increase in corporate bond issuance—both domestic and international—took place during the 1990s in the bond markets in the advanced industrial economies. While

³For instance, see Das (2000), Demirguc-Kunt and Detragiache (1998), Edison (2000), Edwards (1999), Eichengreen and Rose (1998), Kaminsky and Reinhart (1999), Krugman (2000), Krugman (1998) and Reinhart and Rogoff (2004b) among others.

equity issuance slackened after 2000. Corporate bond issuance—both domestic and international— continued as an active alternate source of raising finance.

4. Surge in Global Private Financial Flows to the Developing Economies

Although the decade of 1990s saw several small financial and economic crises, the two crises of 1997 and 1998 had done considerable harm to global investors' confidence in the developing economies, their aptitude and ability for macroeconomic and financial management and their overall creditworthiness. Global investors began considering them to be unsafe economies for investment. The private global financial flows reversed their direction and began moving out of this country group. However, by 2002 market confidence in this group of economies was restored and with that capital market flows began to recover. This was the beginning of a new trend in global private capital flows. Rise in capital flows materialized despite lingering uncertainty about the impact of higher oil prices, rising global interest rates and growing global financial and payments imbalances. Net private capital flows, which included debt and equity, were down to \$187 billion in 2000. They increased to \$274.1 billion in 2003. Bond issuance, bank lending, FDI and portfolio equity all the components of global private capital recorded an increase in 2003. s

There was a noticeable surge after this point, with most of the flows going to a small number of large developing economies. Total debt and equity flows in 2004 amounted to \$412.5 billion and in 2005 \$551.4 billion. This strong surge continued unabated and in 2006 this amount increased to \$760.3 billion. In the latter half of 2007, global capital markets became volatile as the crisis in the US sub-prime mortgage market spilled over into equity, currency and bond markets worldwide. Still the level of flows to the developing economies at the end of the year was \$1025 billion. Notwithstanding the appreciable deterioration in the global financial conditions in the latter part of 2007, private flows to developing countries reached a record level. However, majority of the developing economies still depended heavily on the concessionary loans and grants from the official sources.⁴

4.1 Syndicated Private Bank Lending

Syndicated private bank finances have been an important component of global private financial market flows to the developing economies. The net cross-border syndicated private bank lending flows are defined as the gross lending by syndicated banks minus principal repayments. They were negative during the early years of the decade but began rising in 2003. The net flows soared precipitously after 2004, when they were \$50.4 billion. Syndicated bank lending in 2005 was dominated by the Russian Federation, China and India. Credit rating of many large developing countries improved during 2005. Net syndicated bank lending more than doubled the next year, to \$172.4 billion. It recorded a further dramatic rise in 2007, to \$214.7 billion (Table 1).

Table 1

Cross-Border Syndicated Bank Lending to Developing Countries

⁴ Source of statistical data used in this section is *Global Development Finance 2008* published by the World Bank in December 2008 and its earlier volumes.

(in billions of \$)

Year	Gross Lending	Principal Repayments	Net Lending
2000	116.5	120.4	-3.9
2001	137.6	139.6	-2.0
2002	146.0	147.8	-1.7
2003	175.3	160.1	15.2
2004	235.2	184.7	50.4
2005	285.5	200.1	85.3
2006	397.0	31.3	172.4
2007	454.7	240.0	214.7

Source: The World Bank. 2008. *Global Development Finance 2008*. WashingtonDC. Data gleaned from Table 2.2, Chapter 2, p. 39.

Presently cross-border syndicated bank lending is overwhelmingly dominated by private corporate sector loans by business firms in the BRIC and the other large developing countries. Although sovereign governments also availed of this facility, over the past few years they accounted for a mere 3 percent of the total syndicated bank lending. This scenario is strikingly different from the early 1990s, when the sovereign governments were substantive borrowers and accounted for approximately 15 percent of all syndicated bank lending. The proportion of corporate sector has been rising and it presently attracts over 70 percent of the total syndicated loans. A noteworthy development of 2007 is a dramatic increase in the proportion of bank lending denominated in domestic currency. It was less than 5 percent during 2005 and 2006 but spurted to 11 percent in 2007. Leading borrowers of domestic currency loans were South Africa, China, Brazil and India, in that order.

4.2 Bond Issuance in the International Bond Markets

Bond issuance in the international bond markets grew slowly over the past decades. In the early 2000s, it became a popular instrument of raising capital by the developing countries in global private capital. Net bond flows, which implies bond issuance minus principal repayments, hovered around \$20 billion 2003 but began to soar thereafter (Table 2). In 2006, bond issuances by developing economies declined. However, the very next year it rebounded to \$142.2 billion; the net bond flows rose to \$79.3 billion in 2007. The rebound had occurred due to both, the result of higher bond issuance and lower principal repayments.

Table 2

International Bond Market Flows to Developing Countries

(in billions of \$)

Year	Bond Issuance	Principal Repayments	Net Bond Flows
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2000	69.4	49.9	19.5
2001	54.6	44.4	10.2
2002	49.2	40.8	8.8
2003	68.2	48.6	19.6
2004	102.8	61.7	41.1
2005	115.1	62.5	52.6
2006	105.1	80.6	25.3
2007	142.2	62.9	79.3

Source: The World Bank. 2008. *Global Development Finance 2008*. WashingtonDC. Data gleaned from Table 2.5, Chapter 2, p. 41.

Both private and public corporations from the developing economies traditionally dominated bond issuance in the international bond markets. This tradition has continued thus far. The sovereign bond issuance has had a waning trend. After peaking in 2000 at 75 percent of all developing country bonds, the share sovereign bonds fell below 24 percent in 2007. Conversely, the share of bonds issued by private corporations steadily soared. It was less than 20 percent of the total in 2000. In 2007, it rose to more than 50 percent.

A common characteristic of cross-border syndicated bank lending and bond issuance was that they remained highly concentrated in a small number of large developing economies. Other than the BRIC economies, principal borrowers in these two markets included Mexico, Turkey, Kazakhstan, South Africa, Malaysia and Venezuela. In 2007, the top 5 borrowers in the syndicated bank market accounted for 57.6 percent of the total and in the international bond issuance 51 percent. The same trend of concentration is confirmed by the borrowings of the top 10 borrowers. In the syndicated bank lending market they accounted for 76.7 percent of the total and in the international bond issuance 72.5 percent.

Likewise, the international bond issuance activity traditionally remained concentrated. Its past trend did not show any tendency towards a decline in concentration. In 2003-07 period, five large developing economies accounted for two-thirds of issuance by private corporations and three-quarters of issuance by public corporations. Thus viewed, bond issuance activity was, and continues to be, dominated by business corporations from a few large developing economies. Three in five developing countries have never accessed the international bond market. Until recently, India was the only low-income country to issue bonds in the international bond market on a frequent basis—almost annually. However, the nature of the international bond market is gradually changing. Countries that are first time issuers, and are also low-income, are for the first time being well received by the international bond market. The 2007 bond issuance by Belarus, Ghana, Georgia, Mongolia, Nigeria, Serbia, Sri Lanka and Vietnam are cases in point. Access to the international bond market is geographically broadening. Therefore, it can be expected that bond issuance activity may not remain as concentrated in the future as it was in the past.

4.3 FDI and Portfolio Equities

Equities inflows comprise FDI and portfolio investment. They are two more increasingly important channels through which cross-border global private capital flows to the developing economies. Over the last two decades, cross-border equity capital flows were boosted by the significant implementation of capital market reforms in both developing and advanced industrial economies. These reforms included stock market liberalization, improvement in securities clearance and settlement systems and the development of regulatory and supervisory framework. Aided by macroeconomic restructuring, they propped up domestic financial development. Capital market reforms also fostered and promoted domestic market development through stock market internationalization (Levine and Schmukler, 2006).

Traditionally, equity flows were heavily biased in favor of FDI. However, over the recent period, portfolio flows have begun playing a prominent role. These flows recorded strong gains over the three years period between 2005 and 2007. They reached a high point of \$615.9 billion in 2007 (Table 3). As a proportion of the GDP of the developing economies, FDI and portfolio equity investment was 4.2 percent in 2006. It reached 2.5 percent in 2007, the highest level ever reached by the capital flows through these channels. The trend in portfolio equity flows was different from that of FDI. They were a tiny proportion of the total equity flows at the turn of the 21st century. Gradually they increased and accounted for 20 percent of total equity flows during 2005-07 period (Table 3).

Table 3

Net Equity Inflows to Developing Economies

(in billions of \$)

Year	Net (FDI and Portfolio) Equity Investment	Net FDI Investment	Net Portfolio Equity Inflows
2000	179.0	165.5	13.5
2001	178.7	173.0	5.7
2002	166.0	160.7	5.3
2003	185.9	161.9	24.0
2004	265.9	225.5	40.4
2005	357.4	288.5	68.9
2006	472.3	367.5	104.8
2007	615.9	470.8	145.1

Source: The World Bank. 2008. *Global Development Finance 2008*. WashingtonDC. Data gleaned from Table 2.10, Chapter 2, p. 46.

The largest increase in cross-border equity investments during 2005-07 took place in the Latin American and Caribbean countries. This was reversal of the past trend.

Notwithstanding the reversal, this region's share in global equity stock continues to remain low—almost half of what it was a decade ago. Other regions' share recorded strong increases. In particular, Europe, Central Asia and South Asia recorded substantive increases in equity inflows.

The global FDI flows to developing economies recorded a sharp increase in 2004. The reasons for a rise included marked improvement in investment climate in many developing countries. Corporate earnings in these countries had improved and foreign ownership rules were liberalized. This improvement was reinforced by the strong global recovery from the 2001 recession. As a consequence, FDI flows to developing economies increased to \$225.5 billion in 2004.

The subsequent period was that of strong gains in global FDI. The surge in global FDI continued and they reached a record level of \$1.7 trillion in 2007, over a quarter of which went to the developing economies. Net FDI flows to the developing economies increased to \$470.8 billion, which was 3.4 percent of their GDP. This was marginally higher than their 2006 proportion of 3.25 percent. The increase of \$103 billion in 2007 was more or less evenly distributed across different geographical regions. The Russian Federation and Brazil were the strongest gainers in 2007. China has continued to be the most attractive destination for FDI in the developing world for over two decades, albeit its share has been on a decline in the recent years (Das, 2008). Brazil and Turkey recorded strong gains in FDI flows in recent years, both in absolute and relative terms. The Russian Federation also recorded a rise in FDI in 2007, which was unexpected because investment climate had not improved there. If anything, unfavorable regulations had increased. Nevertheless, global investors were drawn by the potential of high returns in extractive industries.

Over the 2005-07 period, FDI flows to China in dollar terms did not record a large variance. However, its share in total developing country FDI declined from 30 percent in 2002-03 to 18 percent in 2007. FDI accounted for 15 percent of total investment in China in the mid-1990s, this proportion steadily declined to 8 percent in 2006-07. The old strategy of a comprehensive welcome of FDI has changed. The Chinese Government has become increasingly selective in allowing FDI inflows. The FDI proposals are rigorously scrutinized *inter alia* for their technology content and environmental impact. Proposals that show promise of significant technology transfer are approved without much delay. Projects that are to be located in the interior of the country, away from the Eastern and Southern coastal provinces, are preferred. The new strategy is sure to slow FDI inflows in the manufacturing sector, but at the time of accession to the World Trade Organization (WTO) in 2001, China had committed to substantially opening its services sectors to FDI. Foreign banks have been positioning themselves in China. As it opens its insurance and other financial services to FDI, net FDI inflows will pick up momentum again.

After a slow start, since 2004 portfolio equity flows to the developing economies began recording discernibly large increases. In 2006, they increased by 36 billion and in 2007 they jumped again by \$40 billion (Table 3). This increase in dollar terms did not affect the percentage share of portfolio equity flows in the GDP of the recipient countries. They continued to remain 0.9 percent of the GDP. Portfolio equity flows remained heavily concentrated in a small group of large developing economies, the BRIC economies. Of these, Brazil and India have been recording strong increases in recent years, while China a decline. However, this decline was more than offset by large

gains in the portfolio equity investment in Brazil and India. The BRIC and other large developing economies have begun playing an increasingly prominent role in global equity markets. The issuance of equity in these markets “is on par with that of the high-income countries” (WB, 2008; p. 47). When ranked by value of cross-border initial public offerings (IPOs) in 2007, China, Brazil and Russian Federation, in that order, ranked immediately after the US. The BRIC economies are regarded as the largest issuance countries. In 2007, companies located in each one of the four BRICs launched at least one IPO valued at \$2 billion, or more. Returns on cross-border portfolio investment in the stock markets of BRIC economies tend to be high. While the stock markets in BRICs and other large developing economies are more volatile than those in the advanced industrial economies, returns on equity investment in these markets have continued to outperform those in the advanced industrial markets. This has become an established trend.

Claessens and Schmukler (2007) studies data from 39,517 firms from 111 countries to conclude that global financial integration by trading equities and/or cross-listing in major capital markets has increased over time. They found that relatively few countries and firms actively participated and that firms more likely to participate in global equities transactions were from larger and more open economies. Cross-country portfolio investment pattern is influenced by several factors. With the help of a stylized theoretical model, Lane and Milesi-Ferretti (2008b) demonstrated that bilateral equity investment is strongly correlated with the underlying patterns of merchandise trade. This variable was found to be robustly significant in their empirical exercise. It is plausible that the level of trade may be a proxy for bilateral information flows. In addition, international linkages by way of common language and common legal systems are also influential factors. Just the common language factor increased equity holdings by approximately 40 percent. Level of development and the depth of the financial markets are the other factors that affect cross-country portfolio investment. High income countries having a well-developed equity culture tend to hold larger gross foreign equity positions.

Although the above statistical data show the spurt in capital flows to the developing economies, they do not reveal a striking transformation in the status of the developing economies. In the recent past, the external balance sheet of the developing and emerging-market economies has undergone a dramatic change. The net external position of this group of economies has improved significantly. So much so that there has been a reversal in the historical pattern of global financial flows. The advanced industrial economies have slowly become a net issuer of liabilities to the developing world. The old principle of capital flowing from the rich economies of the industrialized world to the have-not economies of the developing world has been turned around. External liabilities of the developing and emerging-market economies have declined. This applies particularly to the debt category. The reason was de-leveraging in several large developing economies as a reaction to the Asian crisis.

Another important recent transformation is that equity instruments, particularly FDI, now account for a much larger proportion of external liabilities than before. This implies that the external investors in the developing economies share production risk to a much greater degree. Besides, owing to accumulation of large official reserves external asset holdings of the developing and emerging-market economies have markedly expanded. This has rendered the monetary authorities in these countries into foreign investors and managers of large funds in hard currencies, an unprecedented

role (Lane and Milesi-Ferretti, 2007). Many GCC and developing economies have established large sovereign-wealth funds (SWFs).

5. Summary and Conclusions

The post-World War-II era began with global financial markets in a moribund state. They needed time to rejuvenate and become operative. The early post-War development of international financial and capital markets was exceedingly slow and far from linear. Due to disturbing developments during the inter-War period, cross-border capital movement was initially regarded by policy mandarins as an anathema. Consequently, the Bretton Woods regime (1946-1973) adopted capital immobility as one of its principal policy pillars.

The floating rate regime was fully compatible with free cross-border capital movements. It lubricated the progress of capital mobility. The 1973 quadrupling of oil-prices occurred, which proved to be a seismic economic event that affected the global economy and financial markets. Around this period, a good number of lower- and upper-middle income developing economies broke from their tradition of following erroneous and unproductive economic strategies. They committed to improving the macroeconomic and financial climate in their economies by carrying out macroeconomic reforms and restructuring of their economies. A series of long-term policy measures were required for economic macroeconomic restructuring. This was done *inter alia* with an objective to make their economies more attractive for the global capital inflows, which in turn helped them integrate with the global financial markets. The indispensable policy measures to achieve this objective were: pursuing macroeconomic stabilization, improving business environment and aiming for stronger economic fundamentals.

The collapse of the Bretton Woods regime was a defining moment for the world of global finance. It was followed by a surge in cross-border capital flows from the private global capital markets. With the largest industrial economies of the world abandoning the concept of capital control and with an increasing amount of financial activity taking place in the Eurodollar markets, other countries had little choice but to open their financial sectors as well. The 1973 quadrupling of oil-prices affected the global financial markets in a significant manner. In the post-1973, cross-border syndicated bank loan market began to pick up momentum.

Brady initiative was launched in the late 1980s. Its express purpose was to resolve the Mexican debt crisis. The Brady bond initiative helped restore investor confidence in the developing economies. Soon the developing country governments began issuing debt outside the Brady market. This mitigated the negative impact of the Latin American debt crisis and financial globalization once again began to flourish.

Developing economies could not remain impervious to the transformations in the financial markets of the advanced industrial economies and the global financial markets for long. Their domestic financial and capital markets reacted to the forces of change in the advanced industrial countries as well as to the ongoing financial globalization and innovation. These forces had a demonstration and learning effects over the developing economies. The period of rapid progress of financial globalization was interrupted by the fallout from some serious crises. The Asian financial crisis (1997-98) unfavorably affected it. Although several economy-specific crises, like the Tequila crisis of 1994, had occurred in the interim, the Asian crisis was the first major

setback to the global economy since the Latin American debt crisis of 1982. The Asian crisis not only mangled the so-called miracle economies of Asia but also the regional economy and affected the global capital and stock markets adversely.

Although financial globalization in the contemporary era proliferated broadly, it did not proliferate evenly across the globe. The extent of integration around the globe varied significantly. Neither all regions integrated financially uniformly, nor all financial crises had comparable impact over financial integration of different economies. Due to the negative impact of the crises of 1997 and 1998 over the global private capital markets and investor confidence, global investors began considering the developing economies to be unsafe for investment. The private global financial flows reversed their direction and began moving out of this country group. However, by 2002 market confidence in this group of economies was restored and with that capital market flows began to recover. This was the beginning of a new surge in global private capital flows to the developing economies.

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