



# Fixing Global Finance

A Developing Country Perspective on Global Financial Reforms

Kavaljit Singh





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**SOMO**

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## Contents

<i>Acronyms</i>	6-7
<i>Data Notes</i>	8
<b>1. The Unfolding of Global Financial Crisis</b>	<b>9</b>
<b>2. The Global Financial Crisis and Developing Countries</b>	<b>22</b>
<b>3. Recent Trends in International Finance and Developmental Implications</b>	<b>30</b>
<b>4. The Rise of New Global Players</b>	<b>36</b>
<b>5. Financial Derivatives and the Globalization of Risk</b>	<b>55</b>
<b>6. Global Financial Crisis and India</b>	<b>59</b>
<b>7. Guiding Principles for Building a Stable Global Financial System</b>	<b>75</b>
<b>8. Global Financial Reforms and Developing Countries</b>	<b>101</b>
<b>9. Global Financial Reforms and Civil Society: A Bottom up Approach</b>	<b>114</b>
<i>Glossary</i>	121-124
<i>Bibliography</i>	125-127

### **List of Boxes**

1. Understanding the Sub-Prime Mortgage Crisis	11-13
2. The Revival of International Monetary Fund	16-17
3. The Collapse of Trade Finance	26
4. The Foreign Exchange Market in India	62
5. Exotic Currency Derivatives Trap Small Exporters in India	72-73
6. Capital Controls Gain Credence	88-89
7. Basel III	92
8. Securities Transaction Tax in India	96
9. Key Policy Proposals	109

### **List of Tables**

1. Global GDP Growth	15
2. The Relationships between Bailout Banks and Hedge Funds	50-51
3. Trends in Capital Flows to India	61
4. Key Indicators of Openness of the Indian Economy	64

## Acronyms

ASEAN	The Association of Southeast Asian Nations
ATMs	Automated Teller Machines
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BoP	Balance of Payments
CAR	Capital Adequacy Ratio
CDOs	Credit Default Obligations
CDS	Credit Default Swap
CECA	Comprehensive Economic Cooperation Agreement
CIS	Commonwealth of Independent States
CRAs	Credit Rating Agencies
ECA	Europe and Central Asia
ECB	European Central Bank
EU	European Union
FDI	Foreign Direct Investment
FII	Foreign Institutional Investor
FOREX	Foreign Exchange
FTA	Free Trade Agreement
GATS	General Agreement on Trade in Services
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
HNWI	High Net Worth Individual
HSBC	The Hongkong and Shanghai Banking Corporation
IFSL	International Financial Services, London
ILO	International Labour Organization
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offer
LIBOR	London Inter-Bank Offer Rate

LBO	Leveraged Buyout
L/C	Letter of Credit
LTCM	Long-Term Capital Management (US based hedge fund)
M&As	Mergers and Acquisitions
MFI	Micro Finance Institutions
MSE	Micro and Small Enterprise
NAFTA	North American Free Trade Agreement
NBFCs	Non-Banking Financial Companies
NGOs	Non-Governmental Organizations
NIM	Net Interest Margin
NPAs	Non-Performing Assets
NPL	Non-Performing Loan
OBE	Off-Balance Sheet Exposures
OFCs	Offshore Financial Centers
OTC	Over The Counter
PE	Private Equity
RBI	Reserve Bank of India
RoA	Return on Assets
RoE	Return on Equity
SEC	Securities and Exchange Commission
SIVs	Structured Investment Vehicles
SME	Small and Medium Enterprise
SPV	Special Purpose Vehicle
SWFs	Sovereign Wealth Funds
TNCs	Transnational Corporations
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
US	United States of America
WOS	Wholly Owned Subsidiary
WTO	World Trade Organization



## **Data Notes**

Million is 1,000,000.

Billion is 1,000 million.

Trillion is 1,000 billion.

Dollars are US dollars unless otherwise specified.

1 US Dollar (\$) = Indian Rupees (Rs.) 45 (As on September 30, 2010).

Indian Financial Year: April-March.

# 1

## **The Unfolding of Global Financial Crisis**

Since 2008, the world economy is in the midst of a severe crisis. The housing market meltdown which was triggered by sub-prime mortgage crisis in the US quickly snowballed into a global financial crisis affecting large international banks and other financial institutions. The sub-prime mortgage crisis is discussed in details in Box 1.

Due to financial interconnectedness, the turmoil that began in September 2008 with the collapse of Lehman Brothers and other Wall Street banks quickly spread to other developed economies including Germany, the UK and Japan.

Post-Lehman collapse, many markets became dysfunctional and several big banks on both sides of the Atlantic had to be rescued from bankruptcy. In most developed countries, the economic growth reversed. International trade and investment flows declined sharply during the current crisis.

The turmoil in the financial sector rapidly spiraled into the real sector, thereby leading to a global economic crisis.

Given the scale and extent of the present crisis, many economists have called it “the worst financial crisis since the Great Depression of the 1930s.”

Some have compared it to the Great Depression. Undeniably, both originated in the US and were global in scope. Some even argue that net impact of current crisis in terms of declines in output, trade volumes and stock markets has been much severe than that of the Great Depression.

### **What Caused the Financial Crisis?**

There are plenty of hypotheses about what caused the global financial crisis, ranging from greed to fraud to regulatory failures. Some analysts have explained the crisis by Hyman Minsky’s Financial Instability Hypothesis while others view it as a structural crisis of global capitalism.

Some experts have blamed national income inequality for playing a significant role in the financial crisis. Some have also pointed out the involvement of big investment banks in facilitating the collapse of housing mortgage markets which triggered the global financial crisis. Undoubtedly, there are elements of truth in all these hypotheses.

However, very few would dispute that there was no single cause of the crisis. Even though the collapse of the sub-prime mortgage markets in the US was the trigger of the crisis, it is now universally considered that a combination of factors contributed in the origin and severity of the crisis.

Some key factors include expansionary monetary policies in major financial centers; developments in the sub-prime mortgage markets of US; extensive use of securitization, complex derivative instruments and shadow banking system; excessive leverage in the financial system; poor assessment of risk in the financial system; lax regulation and supervision by public bodies arising from belief in efficient markets; and global macroeconomic imbalances.

### **The Significance of Crisis**

Contrary to popular belief, financial crises (both banking and currency) occur with increasing regularity. As many as 87 currency crises and 29 banking crises occurred in 25 large developing countries and small developed countries during the 1970-95 period.

Researchers have found that serious financial crises occur every 20 to 25 years. Such crises are followed by significant output losses, massive job losses and deep recession.

As far as developing countries are concerned, financial crises are not a new phenomenon. In the last two decades, major financial crises have occurred in Mexico, Argentina, Brazil, Russia, and the East Asian countries. But it is important to note that unlike most financial crises over the past decades which originated in the developing world (“periphery”), the current crisis originated in the “epicenter” of global financial system – US.

## Box 1

**Understanding the Sub-Prime Mortgage Crisis**

The sub-prime crisis was an outcome of booming housing markets in a poorly regulated financial environment. From 2003 onwards, US housing markets expanded rapidly because interest rates were low. Mortgages to buy homes were pushed on “sub-prime” borrowers – those who do not qualify for market-rate (or prime rate) loans because of their low income or poor credit history.

Lenders relaxed their lending criteria for borrowers: loans were sanctioned without proper verification of income and with few checks and balances. In some cases, loans were given to “NINJA” borrowers – “No Income, No Job or Assets.”

The sub-prime business accounted for some 20-30 percent of all housing loans in the US. These loans were not provided out of altruism, but to earn greater profits: the lenders charged sub-prime borrowers higher than usual interest rates and fees. The onus for the resulting credit crisis thus rests primarily with lenders for their predatory lending practices.

The crisis began when the US Federal Reserve raised interest rates that had been as low as 1 percent to 5.25 percent between June 2004 and June 2006. Sub-prime borrowers could not meet their increased mortgage payments and defaulted.

Until a few years ago, the financial industry’s difficulties stemming from such defaults would have been contained within the United States and limited to the mortgage lender. But the problem got magnified in depth and breadth across financial institutions, countries and sectors because of “securitization.”

In the securitization process, lenders bundle together a number of mortgages and sell them on to a Special Purpose Vehicle, a company usually based in a tax haven. The SPV slices up the bundle (possibly with other loans as well) into tranches (senior, mezzanine or equity), each of which has a different maturity and risk of default or underperformance associated with it.

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Rating institutions, such as Moody's and Standard & Poor's, rate these tranches on the basis of the quality of the underlying asset (the mortgage repayments): senior tranches are usually rated AAA; mezzanine AA to BB and equity unrated.

The SPV then issues and sells Collateralized Debt Obligations (CDO) – securities based on the mortgages – to various investors across the world, including investment banks, hedge funds, insurance companies and pension funds, who buy them so as to receive in return a regular portion of the mortgage repayments.

In the case of mortgages, the CDO is called a Residential Mortgage Backed Security (RMBS) – a right to have a share of the amassed mortgage repayments. The securitization process enabled mortgage lenders to pass on to others the credit risk of the sub-prime borrowers within days of the mortgages being taken out.

With the risks removed so rapidly from their balance sheets, mortgage lenders had little incentive to verify borrowers' credit history. Securitization also helped lenders free up capital for more lending, as they no longer had to put money aside to cover the risks of default on these mortgages. Once the risks had disappeared from their balance sheets, the original lending institutions felt that default was now someone else's problem – that of whoever had bought the mortgage or a share in it. However, some CDOs were structured in such a way that sizeable portions of risk were held on the books of the originating banks.

Many investors bought these CDOs because they had received top AAA ratings and had been structured in a manner that offered higher yields. Many failed to realize the risks involved.

By June 2007, as interest rates rose and borrowers began to default, rating agencies downgraded their ratings of CDOs. Suddenly, investors found that they were holding devalued securities that could not be traded at all. A sharp fall in house prices pushed rates of mortgage defaults even higher. More than 100 mortgage lenders went bankrupt during 2007 and 2008.

The non-depository investment banks and hedge funds, also

*continued on next page...*

known as the shadow banking system, had assumed significant debt burden by providing loans but could not absorb large CDO losses. Because CDOs were bought worldwide, the sub-prime mortgage crisis spread outside the US. Banks with large exposures to sub-prime mortgage markets suffered huge losses, particularly IKB Deutsche Industriebank (Germany), BNP Paribas (France) and Macquarie Bank (Australia).

In particular, global investment banks were badly hit. In March 2008, the US Federal Reserve re-wrote its rule book to rescue Bear Stearns, the fifth largest US investment bank, from collapse on the grounds that it was too entangled with other financial institutions, particularly in credit default and interest rate swaps, to be allowed to fail. Later that month, Bear Stearns was bought by JP Morgan Chase. In September 2008, Lehman Brothers declared bankruptcy while Merrill Lynch was acquired by Bank of America. The last two major investment banks, Morgan Stanley and Goldman Sachs, converted to bank holding companies.

A number of banks and financial institutions received massive injection of public money. In the US, Europe and Japan, central banks intervened to inject liquidity into the global financial system because US and European investment banks no longer wanted to lend money to each other because of the hidden and unknown risks of exposure to CDOs.

The financial crisis raises three important policy lessons. First, in a loosely regulated and poorly supervised financial system, banks and financial institutions can easily indulge in reckless lending to earn fees and quick profits without carrying out “due diligence” on the borrowers. Second, the crisis has revealed that there was considerable risk concentration with the financial intermediaries, rather than its dispersal to outside investors.

Third, poorly regulated rating agencies have become a hazard to financial stability. Paid by those whose securities and financial products they assess, they are subject to a crippling conflict of interest that resulted in their giving top ratings to RMBS despite the decline in lending standards and a slowdown in the housing market.

Even though the crisis originated in the US, banks and financial institutions in Europe were more severely affected by losses related to mortgage investments and subsequent credit squeeze. The International Monetary Fund (IMF) has estimated that more than \$1.3 trillion in bad loans was written off between 2007 and first half of 2009 with additional write-downs of \$1.5 trillion expected over the next few years. Out of total \$2.8 trillion write-downs, European banks are likely to account for \$1.6 trillion.

To restore confidence and liquidity in the banking system, central banks and governments undertook various policy measures such as nationalizing banks, guaranteeing bank liabilities and recapitalization. In the UK alone, state support to the banking sector was £1.2 trillion, almost equivalent to country's annual GDP.

In major developed economies, the governments also undertook unprecedented fiscal stimulus, monetary policy expansion and institutional bailouts. Some of the prominent banks and financial institutions nationalized were Royal Bank of Scotland (UK), IKB (Germany), Fannie Mae and Freddy Mac (US), and Dexia and Fortis (Belgium/Netherlands).

### **The Global Economic Contraction**

The global financial crisis is far more serious than many of its predecessors. The crisis has led to sharp deterioration in the global economy which contracted in 2009, the first time since World War II.

There is not a single country in the world which has not been affected by contagion effects of the crisis through financial or trade channels. However, the degree and nature of contagion effects differ across countries.

The deterioration in the global economy began in early 2008 with most developed countries experiencing a sharp contraction (Table 1). Among the developed economies, Japan was severely hit by the financial crisis. It's GDP growth contracted by 5.4 percent in 2009.

As the crisis unfolded, domestic bank lending contracted in the major

developed economies. Likewise, internationally active banks also cut their cross-border lending substantially.

In particular, the financial crisis has adversely world trade, which witnessed the largest decline in the past 80 years. The International Monetary Fund has reported that world trade contracted by 12.3 percent in 2009.<sup>1</sup>

The trade collapse was not merely restricted to the developed countries but encompassed a large number of poor and developing countries. Interestingly, the decline in cross-border trade in goods was greater than the decline in trade in services. In fact, trade in certain services (such as professional and IT) has remained buoyant due to their less dependence on external financing.

Of late, there are some signs of recovery of trade in the Asian region led by China, but globally the trade crisis is far from over.

The collateral damage of the crisis in terms of foreclosed homes, wealth destruction, bankruptcies and financial losses is colossal. Jorge Nascimento Rodrigues has estimated the total cost of global financial crisis at \$69 trillion

**Table 1: Global GDP Growth (in Per cent)**

Country / Region	2009	2010
US	(-) 2.7	1.5
UK	(-) 4.4	0.9
Euro Area	(-) 4.2	0.3
Japan	(-) 5.4	1.7
China	8.5	9.0
India	5.4	6.4
Advanced Economies	(-) 3.4	1.3
Emerging and Developing Economies	1.7	5.1
<b>World</b>	<b>(-) 1.1</b>	<b>3.1</b>

Source: *World Economic Outlook*, IMF, October 2009.



## Box 2

**The Revival of International Monetary Fund**

The global financial crisis has dramatically changed the world of International Monetary Fund (IMF). Before the onset of the crisis, the IMF was drifting into irrelevance.

The relative calm in financial markets in the early 2000s meant very few countries knocking on the doors of the IMF for financial assistance and policy advice. It had become fashionable in certain circles to predict the decline and ultimate demise of the IMF.

Against the backdrop of excessive liquidity and booming financial markets, there was a strong belief that the ascendancy of financial markets and private financial institutions would make official institutions (such as IMF) obsolete. However, the global financial crisis has completely changed this thinking.

Instead of demise, the crisis has given a new life to the IMF. The crisis has enhanced the IMF's role in crisis management and given it a key role in managing the global financial system.

As part of counter-cyclical measures, IFIs (and governments) have stepped-in to restore stability in the financial markets and stimulate real economy. Several policy measures (both short and long-term) have been announced by IFIs and regional developmental banks at various levels to mitigate the negative impacts of the crisis.

Since the onset of crisis, the World Bank has committed a record \$88 billion in loans, grants, equity investments, and guarantees.

Post-crisis, many developing countries have approached IMF for financial assistance. Several steps have been taken to expand the IMF's financial resources. At the G20 London Summit in April 2009, leaders agreed that the New Arrangements to Borrow (NAB) should be increased to \$550 billion from the current \$50 billion in order to strengthen IMF's capacity to respond in the event of a crisis. The NAB provides financial assistance above and beyond the quota resources provided by member-countries.

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In April 2010, the IMF board approved the ten-fold increase in the size of NAB. Although many developing countries have also contributed resources, but the US and Japan remain the largest contributors to the NAB.

In addition, a general allocation of Special Drawing Rights (SDRs) equivalent to \$250 billion has been approved to boost global liquidity. Almost \$100 billion of the general allocation will be provided to developing countries, of which low-income countries will receive over \$18 billion.

Critics have pointed out that much of financial assistance by IMF and multilateral developmental banks in the post-crisis period has been focused on middle-income developing countries. Besides, the actual pace of disbursements of assistance has been extremely slow. A study by US-based Centre for Economic and Policy Research (CEPR) found that 31 of the 41 IMF agreements contain pro-cyclical macroeconomic policies which would further aggravate the conditions in the borrowing countries.<sup>2</sup>

which includes wealth destruction, writedowns, contraction in world trade and GDP, and public budget interventions.<sup>3</sup>

### **Social Dimensions of Financial Crisis**

The global financial crisis has turned into a global social crisis. It has been estimated that the financial crisis could push 90 million more people into extreme poverty worldwide by the end of 2010.<sup>4</sup>

According to the International Labour Organization (ILO), twenty-seven million people around the world lost their jobs in 2009 and about 12 million of the newly unemployed were in North America, Japan and Western Europe. Even in developing countries, employment levels may not reach pre-crisis levels before 2013. The impact of jobs crisis is more acute for the low-skilled workers.

The jobs crisis is unlikely to be resolved soon due to sluggish and jobless

recovery. Unlike bailing out big banks, the strong political will to protect and create jobs is squarely lacking at both national and global levels. By and large, fiscal stimulus and other measures announced by governments lack focus on employment generation and social protection.

The developed countries are facing a far worse social crisis than the financial crisis. Predictably, the impact of the economic downturn has been severe on most vulnerable sections of their society.

In the US, the number of people living in poverty and without health insurance is rapidly rising. The statistics compiled by US Census Bureau reveal that 43.6 million people (or one in seven Americans) lived in poverty in 2009, up from 39.8 million in 2008. The US poverty rate (14.3 percent) in 2009 was the highest since 1994. Besides, the number of Americans without health insurance jumped to 50.7 million in 2009 from 46.3 million in 2008.

In Europe, the implementation of tough austerity measures signals the demise of European Social Model.

For poor and developing countries, the financial crisis has worsened poverty and income distribution and thereby reversed gains in poverty reduction of the last decade. In particular, the poor and vulnerable sections of population in these countries have been worst hit. It has been estimated that 64 million more people will fall into extreme poverty in 2010.

Although real-time data is still not available, a recent World Bank Report estimated that the crisis threatens the welfare of over 160 million people living on living around the poverty line in Europe and Central Asia (ECA) region.<sup>5</sup> The Report examined the impacts of the global financial crisis at the household level through credit market shocks, the increasing prices of goods and services, and rising unemployment. The Report claimed that “By 2010, about 11 million more people could fall into poverty and an additional 24 million people could find themselves vulnerable, or just above ECA’s international poverty line, over the next two years.”<sup>6</sup>

A micro-simulation approach to assess the poverty and distributional effects in Bangladesh, Mexico, and the Philippines also found that poverty levels will increase by over a million in these countries in the post-crisis period.<sup>7</sup>

According to a recent estimate of World Bank researchers, between 30,000 and 50,000 additional children may have died of malnutrition in 2009 in Sub-Saharan Africa because of the financial crisis.<sup>8</sup>

There is a growing concern that the international aid to the poor and developing countries will fall at a time when it is needed badly. Since the financial crisis began in the developed world, the quantum of international aid may decline as the incomes of donor countries have substantially fallen besides there are high fiscal costs associated with the crisis. Even before the crisis, many developed countries were unable to meet the aid targets as promised under the Monterrey Consensus on Financing for Development (2002). Post-crisis, aid commitments are under severe pressure due to economic downturn.

The likelihood of declining international aid could have far-reaching effects for developing countries which lack fiscal strength to deal with external shocks. Since social welfare programs in many African countries are heavily dependent on international aid, it would make poor people more vulnerable.

As 2015 is fast approaching, the Millennium Development Goals (MDGs) to fight hunger and poverty on a world scale are unlikely to be achieved. In particular, it will be very difficult for Sub-Saharan Africa to meet a number of MDGs due to enormous economic constraints put by the crisis.

### **Is the Financial Crisis Over?**

Despite massive bank bailouts and fiscal stimulus packages announced by governments, the global economy recovery is still not in sight with faltering demand and falling production, a squeeze in credit markets and growing

job losses. In the US and Europe, the main macroeconomic indicators continue to be adverse. The unemployment rates are expected to remain high in the coming years.

With most developed economies still not completely out of recession, few developing economies, particularly from Asia, provide some signs of early recovery, albeit at a slower pace. The signs of early recovery are more pronounced in those developing countries (such as China and Brazil) which maintain greater policy space and less binding international commitments that allowed them to pursue expansionary fiscal and monetary policies.

Financial markets may appear stabilized but have shown weakness in the wake of new trouble spots such as Greece debt crisis. The near default of Greece has demolished the notion that developed countries have overcome financial crisis. Greece is not alone. The specter of sovereign default is returning to a number of developed countries.

It is now being recognized that the lack of coordination and the inadequacy of international policy responses to the current crisis may create the next financial crisis. The rescue and stimulus measures have failed to address the structural imbalances that lie behind the crisis.

There are serious concerns that the loose monetary and fiscal policies currently adopted by many developed countries are promoting “carry trade” and short-term speculative capital inflows into developing countries which, in turn, can create new asset bubbles in these economies. Thus, the potential costs associated with such volatile capital inflows cannot be overlooked and fast-recovering developing countries should adopt a cautious approach towards volatile capital flows. The real challenge before developing countries is to how to control and channelize such inflows into productive economy.

How long will the global financial crisis last? No one really knows. The new signs of risks are fast emerging at the global level. The developments related to Dubai World and Greece’s sovereign debt indicate that the effects of the financial crisis will continue to be seen for years to come.

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**Notes**

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## 2

### **The Global Financial Crisis and Developing Countries**

The impact of financial crisis was so severe in the developed world that its impact on the poor and the developing world was largely overlooked.

Initially, the adverse impact was observed in highly open developing economies (such as Singapore and Mexico) due to their deeper linkages with global financial markets.

Even though most developing countries had no direct exposure to risky sub-prime loans and associated financial instruments, their real economy was adversely affected by sharp contraction in both external and domestic demand.

Unlike the financial shock which was essentially limited to highly open developing economies, the trade shock was much more widespread and severe. The industrial production and manufacturing exports witnessed the sharp slowdown in the developing world.

Fall in commodity prices and sudden capital outflows (due to global deleveraging) further exacerbated the economic downturn in the developing world. The real output fell by 4 percent between October 2008 and March 2009. By the first quarter of 2009, 25 of 31 developing countries had reported negative growth rates.<sup>1</sup>

Undeniably, the impact of the crisis varies across developing countries, depending on their peculiar economic and financial situations. Except China and India, most developing countries have experienced significant lower economic growth.

China and India have been able to maintain economic growth due to massive fiscal stimulus packages and expansionary monetary policies. In addition, greater presence of state-owned banks and financial institutions

helped both China and India to inject massive financial resources to stimulate the domestic economy.

In contrast, some developing countries (such as Chile) could not overcome credit squeeze as their banks were heavily dependent on external funding.

### **ECA: Transition to Financial Crisis**

Countries in developing Europe and Central Asia (ECA) region were worst hit by the crisis. Their GDP fell by 6.2 percent on account of lower oil prices and problems in financing unsustainable current account deficits.

Since mid-1990s, financial openness played an important role in ECA's integration with the global economy. Financial openness facilitated greater presence of foreign banks in the domestic financial system. Within a short span of time, foreign banks acquired majority stakes in the domestic banking markets of these countries. In Slovak Republic and Estonia, foreign banks share in total banking assets was as high as 98 percent.

During 2002-07, Eastern Europe received almost one-third of all private capital flows to the emerging markets. The banking sector was one of major recipients of FDI. There was excessive credit growth to the private sector due to large external inflows. In Estonia and Latvia, foreign currency loans constituted over 80 percent of bank loans in 2008.

Until the crisis, the ECA region had experienced a massive consumption boom financed by external bank credit and investment flows. However, the large presence of foreign banks made this region extremely vulnerable to the crisis.

When the crisis erupted, these economies were badly hit because Western banks immediately withdrew funds from their subsidiaries operating in the region.

Latvia, which joined the European Union in 2004 and enjoyed rapid economic growth during 2000-07, suffered the worst financial crisis in its



modern history. Its GDP contracted by 18 percent and unemployment reached 20 percent in 2009.

The prospects of recovery and growth in the ECA region are very bleak. The depressed economic conditions are likely to prevail for some years.

### **Decline in Private Capital Flows**

During the financial crisis, private capital inflows (particularly cross-border bank lending and portfolio investments) to the developing world witnessed a sharp decline, from \$617 billion in 2007 to \$109 billion in 2008. Global foreign direct investment (FDI) inflows also declined from \$1.7 trillion in 2008 to \$1 trillion in 2009.

The decline in FDI inflows was witnessed in all regions. The volume of global cross-border mergers and acquisitions (M&As) by international firms declined 36 percent in 2009.

Many developing countries experienced falls in their exchange rates due to sudden withdrawal of capital by foreign investors.

The total external financing needs of developing countries were estimated to be \$1.2 trillion in 2009. With a financing gap of over \$600 billion, developing countries resorted to lower imports along with massive use of their foreign exchange reserves and fresh borrowings from international financial institutions.

### **Decline in Inward Remittances**

Inward remittances are an important source of household incomes and foreign exchange reserves in many poor and developing countries. In recent years, remittance flows experienced double digit growth.

Since 2008, inward remittances have fallen in many developing countries due to decline in economic activity in recession-hit developed countries. In addition, many host countries have tightened immigration controls.

According to the World Bank statistics, officially recorded remittance flows to developing countries were \$316 billion in 2009, down 6 percent from \$336 billion in 2008.

In the case of Latin American countries such as Mexico, inward remittances have declined due to deterioration in the US job markets. In ECA region, inward remittance flows were much lower in 2009 than pre-crisis levels.

In contrast, many South Asian countries (such as India and Pakistan) which receive substantial workers' remittances from Middle East and Asia did not experience a downward trend.

### **Contraction in World Trade**

As mentioned in the previous chapter, global trade collapsed during 2008-09 at a pace not seen since the Great Depression. The decline in world trade was largely due to sharp contraction in global demand for goods.

In particular, those developing economies, which are far more dependent on trade for growth, were worse hit through trade channels. Export growth witnessed a significant slowdown. This was the case with most Asian economies which follow export-led growth model and are heavily dependent on US and European markets. The signs of trade shocks are still visible in many Asian economies.

In the case of Sub-Saharan Africa, the financial crisis had very limited impact through financial channels as most African banks and financial institutions had very little or no direct exposure to sub-prime loans.

In many ways, Africa's low level of financial integration with the developed world turned out to be a blessing in disguise. However, the real impacts of crisis were felt through trade channels given the fact that African exporters rely heavily on external trade finance.

Those African countries which largely rely on export and tourism for

## Box 3

**The Collapse of Trade Finance**

The global market for trade finance (both credit and insurance) began deteriorating in mid-2008, with the squeeze in liquidity and growing concerns over counter-party risk and payment defaults. Banks were not willing to increase credit lines due to increased volatility in global currency markets and reduced inter-bank lending. The decline was much sharper in early 2009.

Initially, the decline was limited to developed countries' markets as the financial crisis originated there, but by the end of 2008 it soon spread to the rest of the world. In particular, Asian and Latin American countries, which mostly rely on developed countries for exports, were badly affected in the first half of 2009. Commodity exporting countries from Africa were also affected by the drop in international commodity prices.

The international commercial banks and private insurers became more risk averse to support cross-border trade and investments. The result was that demand for trade finance far exceeded supply. Various estimates from industry and World Bank put the market gap in trade finance in the range of \$25 billion to \$500 billion during late 2008-early 2009.

The deterioration in trade finance markets led to sharp rise in Spreads on credit and insurance costs which, in turn, made trade finance transactions more expensive.

In the case of India, Brazil and other large developing countries, the Spreads on 90-days L/Cs soared to 300 to 600 basis points above the London Inter-Bank Overnight Rate (LIBOR), compared to 10 to 30 basis points in normal times. In some countries (for example, Chile), markets for trade finance products with 365 days and above tenors almost disappeared during the crisis.

In the case of export credit insurance, the impact of the crisis was more on the volumes of short-term commitments which dropped 22 percent between the second quarter of 2008 and the third quarter of 2009. However, medium to long-term trade insurance commitments remained stable during the crisis.

foreign exchange and jobs have been negatively affected due to fall in consumption and imports in recession-hit Western economies.

In the aftermath of crisis, the decline in US imports from Africa has been much larger than from other regions.

The world trade has also been adversely impacted by the reduced availability of trade finance which affected both the production and export capacities of companies (Box 3).

As trade and finance have very strong inter-linkages, trade finance (which is usually considered to be safest form of credit since it is backed by strong receivables in the form of specific goods or services) became highly vulnerable during the financial crisis.

Since economic activity of many developing economies was badly affected by trade channels, they attempted to revive exports through a variety of policy measures including boosting trade finance and expansion of export credit agencies.<sup>2</sup>

### **Fall in Commodity Prices**

The falling commodity prices have further hurt a number of energy and metal exporting African countries.

According to *Global Economic Prospects 2010*, between July 2008 and February 2009, the US dollar price of energy plummeted by two-thirds, and that of metals dropped by more than 50 percent, from earlier highs.<sup>3</sup> Dollar prices of agricultural goods retreated by more than 30 percent, with the prices of fats and oils dropping 42 percent.<sup>4</sup>

Falling commodity prices coupled with declining investment flows have adversely affected the balance of payment positions of many poor and developing countries. Consequently, a number of countries approached the IMF for financial assistance.

Some poor countries are facing higher debt-GDP ratios and debt

servicing obligations which, in turn, would further weaken the growth prospects.

### **The Decoupling Myth**

In many ways, the financial crisis has demolished the hypothesis that developing economies have been effectively “decoupled” from developed ones. The “decoupling” hypothesis was intellectually fashionable before the crisis. But the crisis has demonstrated beyond doubt that irrespective of the nature and degree of global integration and the soundness of domestic macroeconomic policies, no country can insulate itself from external shocks in a globalized economy.

### **Rebalancing of Financial Power?**

Paradoxically, the crisis has accelerated the trend towards a multi-polar financial industry. With the rising share of large and fast growing developing countries (such as China, India and Brazil) in the global economy, the landscape of financial centers is set to change – both geographically and functionally.

Despite the fact that over two-thirds of global banking assets remain concentrated in traditional financial centers in the US and EU, their dominance is being challenged by banks and financial institutions from the developing world, particularly from BRICs. In the top 1000 listing, for instance, the number of banks from BRIC economies has risen from 43 in 1989 to 130 in 2009 and 146 in 2010.

The rapid growth of stock markets in large developing economies is another indicator of this trend. Furthermore, Islamic finance is fast emerging in the Asia and the Gulf region. The revival of G20 also signals the growing influence of big developing economies in international policy making. Nevertheless, it remains to be seen how far a new global economic order would emerge with the rise of new financial centers from the developing world?

**Notes**

1. World Bank, *Global Economic Prospects: Crisis, Finance, and Growth*, 2010, p. 25.
2. For details, see Kavaljit Singh, *The Changing Landscape of Export Credit Agencies in the Context of the Global Financial Crisis*, FERN, March 2010 (<http://www.fern.org/changinglandscape>).
3. World Bank, *op. cit.*, p. 32.
4. *Ibid.*

# 3

## **Recent Trends in International Finance and Developmental Implications**

The starting point in any discussion on global financial reforms should be an assessment of key developments that has shaped the global financial system (or rather “non system”) over the past few decades. These developments will help in understanding the nature and dynamics of rapidly changing landscape of global finance.

Since the 1980s, the global financial system has undergone tremendous changes. Financial liberalization in both developed and developing countries is one of most important factors behind increased capital mobility on a global scale.

Financial liberalization has two interrelated components – domestic and international. Domestic financial liberalization encourages market forces by reducing the role of the state in the financial sector. This is achieved by removing controls on interest rates and credit allocation as well as by diluting demarcation lines between banks, insurance and finance companies. International financial liberalization, on the other hand, demands removal of capital controls on inflows and outflows of capital. By allowing cross border movement of capital, it deepens global financial integration and free flow of capital across borders.

Other key developments such as the stagnation in the real economy due to overcapacity and over production, lower interest rates in the developed economies, and rapid technological changes in communications and IT have also enabled massive expansion of footloose finance capital across borders. In addition, new financial instruments and financial intermediaries have drastically changed the basic function of the financial sector.

It is a well acknowledged fact that financial sector exists to serve the real economy. But in the last two decades, the global financial sector has

become so big that has led to a tail (financial sector) wagging the dog (real economy) kind of situation.

### **Financial Innovation, Deregulation and Globalization**

Financial innovation played an important role in changing the dynamics between finance and real economy. It facilitated the introduction of new financial instruments (such as derivatives) and increased distance between financial instruments and productive assets. Certain kinds of innovation added to the complexity of the financial system.

The removal of regulatory measures led to the emergence of market-based financial system. In the US, the Banking Act of 1933 (popularly known as the Glass-Steagall Act) came into existence in the wake of Great Depression. The Glass-Steagall Act separated commercial banking from investment banking and also led to the establishment of the Federal Deposit Insurance Corporation (FDIC), a government agency which provides deposit insurance. Under the influence of free-market doctrine, the Glass-Steagall Act was repealed by the Gramm-Leach-Bliley Act in 1999. The repeal allowed investment banks, depository banks and insurance firms to consolidate and created the legal framework for the emergence of universal mega banks such as Citigroup.

Following a similar approach, the UK allowed banks to enter the securities business in 1986. In Europe, the introduction of single banking license in 1989 gave a boost to cross-border banking.

Since the mid-1980s, many developing countries also undertook steps to deregulate and open up domestic financial sector to international competition. The structural adjustment programs and trade agreements played a vital role in the removal of restrictions in banking and financial services. These developments led to the emergence of internationally active banks which fueled the large-scale mergers and acquisitions in the banking and financial services globally.

To a large extent, the implicit taxpayer guarantee drove banks to expand



nationally or internationally rather than achieving any economies of scale. Empirical studies have shown that there are no significant economies of scale in banking. On the contrary, diseconomies of scale prevail when large banks undertake mergers and acquisitions.

Since the mid-1990s, financial conglomerates with significantly large balance sheets (and off-balance-sheet positions) have become an important part of the global financial landscape. In the US, for instance, the top ten financial conglomerates were holding more than 60 percent of financial assets in 2008, as compared to merely 10 percent in 1990. The financial conglomerates rapidly expanded their activities in wholesale markets, equity markets and derivatives.

Simultaneously, shadow banking institutions emerged outside the traditional banking system. These institutions include hedge funds, SIVs, finance companies, asset-backed commercial paper (ABCP) conduits, money market mutual funds, monolines and investment banks. The shadow banking institutions grew in importance as they acted as intermediaries between investors and borrowers. Bear Stearns, Lehman Brothers, Fannie Mae and Freddie Mac are some of the prominent examples of shadow banking institutions.

In its heyday, the shadow banking system was considered as an integral part of the free-market economy. Since shadow institutions do not accept deposits like a depository bank, they are not subject to similar capital requirements and regulatory oversight. Usually, such institutions tend to use a very high level of leverage. Driven by excessive liquidity and light-touch regulation, shadow banking system expanded dramatically in the years leading up to the crisis. In 2008, shadow banking system had as much as \$20 trillion worth of liabilities, significantly larger than the liabilities of the traditional banking system at about \$13 trillion.

As discussed in Chapter 1, the shadow banking institutions played an important role in the sub-prime mortgage meltdown in 2008. Post-crisis, the activities of the shadow banking system have come under closer scrutiny and regulations.

### **Financialization of Economy**

One of the recent developments is the excessive financialization of economy with greater importance to financial activity over non-financial economic activity.

In the US, for instance, the financial sector has grown by leaps and bounds in the last three decades. As illustrated by Simon Johnson, former chief economist of the IMF, financial industry's share in the total US corporate profit was 16 percent between 1973 and 1985.<sup>1</sup> In the 1990s, it ranged between 21 and 30 percent.<sup>2</sup> However, just before the crisis broke out, 41 percent of the profits of the entire US corporate sector went to the financial industry.<sup>3</sup> In the same vein, wages in the US financial sector reached 181 percent of average compensation in domestic private industries in 2007.<sup>4</sup>

In the case of UK, the share of financial services in GDP rose to 8.3 percent in 2007, from 5.3 percent in 2001.

Such developments have led to a situation where the financial sector increasingly serves itself, exhibiting high growth and profits, while doing relatively little for the non financial sectors of the economy, which the financial sector exists to serve in principle. In the words of Robert Reich, the former US Labor Secretary, "Before 1980, Wall Street had been the handmaiden of industry, helping large oligopolies raise capital when necessary. After 1980, industry became the handmaiden of Wall Street."

### **The Growing Domination of Speculative Finance Capital**

The global financial markets have moved beyond their original function of facilitating cross border trade and investment. The financial markets are no longer a mechanism for making savings available for productive investments. Nowadays, global financial flows are less associated with the flows of real resources and financing long-term productive investments.

As the value of global foreign exchange trade is many times more than

the value of annual world trade and output, much of global finance capital is moving in search of quick profits from speculative activities rather than contributing to the real economy.

Every day, trillions of dollars move in the world's financial markets in search of profit making opportunities from speculative investments. These flows are largely liquid and are attracted by short-term speculative gains, and can leave the country as quickly as they come.

That is why, many analysts have described this phenomenon as “casino capitalism.”<sup>5</sup> In fact, it is “casino capitalism” that very often perpetuates economic disasters thereby adversely affecting the lives of millions of ordinary people. As Susan Strange puts it succinctly:

For the great difference between an ordinary casino which you can go into or stay away from, and the global casino of high finance, is that in the latter we are all involuntarily engaged in the day's play. A currency change can halve the value of a farmer's crop before he harvests it, or drive an exporter out of business. A rise in interest rates can fatally inflate the costs of holding stocks for the shopkeeper. A takeover dictated by financial considerations can rob the factory worker of his job. From school-leavers to pensioners, what goes on in the casino in the office blocks of the big financial centers is apt to have sudden, unpredictable and unavoidable consequences for individual lives. The financial casino has everyone playing the game of Snakes and Ladders.<sup>6</sup>

The growing presence of financial players (non-end users) in commodity and agricultural markets should be a matter of serious concern for global policymakers. Financial speculation is now well recognized as one of the major contributors in extreme price volatility in commodity and agricultural markets. A study by SOMO found the growing influence of “non-traditional” institutional investors (such as hedge funds) in agricultural markets.<sup>7</sup>

The sharp rise in global food prices during 2006-08 and subsequent

food riots in many countries have alarmed the policymakers about the increasing interconnectedness of global finance and agricultural markets. The convergence of financial and food crises reveals that financial reforms are necessary to curb excessive speculation.

Excessive speculation by large players is a significant factor in market manipulation and unreasonable price movements and therefore has the potential to distort the normal functioning of a market.

There are numerous ways in which the domination of speculative finance capital negatively affects the real economy. Firstly, by providing economic incentives to gamble and speculate on financial instruments, the global finance capital diverts funds from long-term productive investments.

Secondly, it encourages banks and financial institutions in developing countries to maintain a regime of higher real interest rates which significantly reduces the ability of productive industries and enterprises in terms of access to credit. Lastly, finance capital (because of its speculative nature) brings uncertainty and volatility in interest and exchange rates, thereby affecting trade and other components of real economy.

### Notes

1. Simon Johnson, "The Quiet Coup," *The Atlantic*, May 2009.
2. Ibid.
3. Ibid.
4. Ibid.
5. See, for instance, Susan Strange, *Casino Capitalism*, Blackwell, 1986.
6. Ibid., p. 2.
7. Thijs Kerckhoffs, Roos van Os and Myriam Vander Stichele, *Financing Food: Financialisation and Financial Actors in Agriculture Commodity Markets*, SOMO Paper, SOMO, April 2010 ([http://somo.nl/publications-en/Publication\\_3471/at\\_download/fullfile](http://somo.nl/publications-en/Publication_3471/at_download/fullfile)).

# 4

## The Rise of New Global Players

Over the years, several new players have emerged in the global financial landscape. These players, also known as the “new power brokers,”<sup>1</sup> have significantly altered the global financial landscape by diffusing financial power and influence of traditional financial institutions such as commercial banks, mutual funds and pension funds.

However, the global financial crisis has altered the growth of new financial players – both quantitatively and qualitatively. The crisis has raised important questions about their financial clout, future growth, ethics and social value.

A complete assessment of all new financial players is beyond the scope of this book. However the role of important financial actors such as private equity firms, sovereign wealth funds and hedge funds (particularly in the context of developing countries) is discussed below.

### Private Equity Funds

Private equity is a broad term denoting any investment in assets or companies that are not listed on public stock exchanges. Private equity funds are pools of capital managed and invested by private equity firms.

In the last two decades, private equity has become an important component of global finance capital, developing its own distinct characteristics and practices. Until the onset of financial crisis, newspapers and TV news channels were full of stories about multi-billion private equity buyout deals. Supporters crowned private equity funds the “new kings of capitalism,”<sup>2</sup> while critics labeled them “locusts.”<sup>3</sup>

Private equity has a significant and distinctive influence on taxation policy, corporate governance, labor rights and public services, deeply affecting society, human rights and environment alike. Were they to be assessed in terms of annual revenues, several private equity firms would

rank among the world's top 25 corporations. The biggest five private equity deals have involved more money than the annual public budgets of Russia and India.<sup>4</sup> Some executives of private equity firms earn billions of dollars in fees and profits, often at the expense of the companies they buy and sell.

Private equity firms do not take long-term stakes in the companies in which they invest and show little interest in improving the productive capacity of companies or in launching new products and services. For private equity firms, every investment is simply one element in a portfolio of financial assets that move in and out of companies as the market demands (rather than as the long-term health of the companies requires).

Private equity firms tend to buy companies not to own and run them with a long-term perspective (as foreign direct investors such as Siemens or Vodafone might do by investing in a manufacturing plant or telecommunications network), but in order to sell them on at a profit as soon as they can.

The involvement of pension funds, university endowments and sovereign wealth funds in private equity businesses means that in fact a significant amount of money flowing into private equity funds globally is "public" in nature, not private. Some development finance institutions such as the World Bank's International Finance Corporation (IFC), the Asian Development Bank and Germany's Investment and Development Company have also invested in private equity funds. Yet these outside investors do not participate in the funds' investment decisions.

The five largest private equity firms are The Blackstone Group, The Carlyle Group, Bain Capital, TPG Capital (formerly Texas Pacific Group) and Kohlberg Kravis Roberts & Co. (KKR). Together, these companies manage assets worth hundreds of billions of dollars. Their influence over the "real economy" can be gauged from the fact that these five firms alone control companies that employ more than two million workers.

In 2006, their most recent peak year, PE firms carried out more than \$664 billion worth of buyouts, according to data firm Thomson Financial.

### **The Buyout Business**

Once private equity firms buy out companies, they invariably downsize the workforce, slash workers' benefits and abrogate collective agreements between workers and management. Even the proponents of private equity admit that buyout deals lead to significant job losses, particularly in the initial years. Unlike publicly listed companies, private equity firms are not legally bound to disclose information about their operations or those of the companies in which they invest or buy. As a result, they (and the companies they own) are shielded from the glare of public attention and from public accountability.

Private equity firms have made extensive use of "leveraged" or borrowed finance to buy out companies – they borrow money to acquire a company's shares in hopes that the interest they will pay on the resulting debt will be lower than the returns they will make from their investment. In many cases, the levels of borrowing are unsustainable.

Private equity investments can also threaten hospitals, water supplies and other public services when they buy firms involved in these services because they place short-term financial objectives over the public interest. The way that the private equity business model exploits regulatory loopholes, tax arbitrage and offshore entities and transactions can further endanger the public good. Furthermore, when several big private equity firms join hands to buy a target company, the significant flow of price sensitive information creates considerable potential for market abuse.

### **The Boom and Bust Cycle**

Pre-crisis, the period from 2000 to mid-2007 witnessed low interest rates, a worldwide glut of capital, buoyant credit markets, rising corporate profits and a massive growth in structured credit products such as collateralized debt obligations. The resulting easy liquidity in the global financial markets nourished a boom in the private equity business. Wealthy investors were encouraged by low interest rates to look for more remunerative investment options. Big institutional investors, such as pension funds, found it

preferable to invest in a big private equity fund rather than holding direct stakes in several companies. Big investment banks, too, entered the private equity business to serve their own commercial interests. Attracted by the advisory fees they would get for arranging deals, particularly leveraged buyouts, they eagerly lent money to private equity funds.

In 2006, global investment banks such as Goldman Sachs and JP Morgan Chase picked up \$12.8 billion in fees from private equity firms, and in the first half of 2007 alone, another \$8.4 billion. Some investment banks (such as Goldman Sachs) launched new private equity funds to benefit from the boom, while others (such as Citigroup) simply continued to use their own capital to underwrite buyout deals.

Post-crisis, the turbulence in the credit markets and the resultant credit squeeze has negatively affected the global private equity industry, which has largely relied on leveraged finance to acquire companies. The lifeblood of private equity – cheap debt – quickly vanished. The crisis has made it more difficult and more expensive for private equity firms to borrow money for their buyouts. Besides, it has also negatively affected the portfolio companies of private equity firms.

In many ways, the financial crisis crunch has broken the popular myth that the boom in private equity is the result of an efficient business model based on superior management skills and “patient capital” that does not expect immediate returns. A report by UK-based Centre for the Study of Financial Innovation noted that buyout firms do not always run companies better and called for greater transparency around private equity performance.<sup>5</sup>

To a large extent, the private equity business was all about debt assembled in a DIY (Do-It-Yourself) fashion by financiers. Governments, central banks and public monetary authorities chipped in with a supply of easy money, lax credit controls and tax concessions.

But the eruption of global crisis does not necessarily imply the end of the private equity business. It could well bounce back from the slump just



as it did previously in the late 1980s and early 1990s. The fact that private equity firms have more financial muscle than they used to, and closer linkages with other global financial actors, such as hedge funds, sovereign wealth funds and banks, increases the chances of a comeback.

### **Private Equity in India**

Post-crisis, big Asian economies (India and China) have become more attractive for private equity firms. Apart from raising money from the Middle East and Asia, the private equity industry is also looking to invest there at a time when US and European markets are saturated. India, China and the Middle East are also likely to see more home-grown private equity funds, which will invest both within and outside the region.

India is one of the favorite destinations of PE investments, accounting for more than half of all PE inflows into BRIC (Brazil, Russia, India and China) countries in 2007. The PE investments in India jumped from \$2.2 billion in 2005 to \$17 billion in 2007.

Returns on private equity investments in India have been much higher. The mind-blowing profits made by the US-based private equity firm Warburg Pincus in an Indian mobile telephone service provider, Bharti Telecom, are a case in point. Warburg Pincus made an investment of \$300 million in Bharti Telecom during 1999-2001 and exited in 2005 with a total return of \$1.92 billion – almost seven times its original investment. Such fabulous profit opportunities have dwindled in traditional markets.

More than 100 private equity firms already operate in India, including some of the biggest firms: The Blackstone Group, The Carlyle Group, Warburg Pincus, KKR, and 3i. Lately, some big private equity firms have also launched specifically India-focused funds.

Private equity investments in India keep shifting from sector to sector. Of late, infrastructure, real estate, banking and financial services, media and entertainment sectors have attracted more interest than traditional sectors such as information technology, information technology-enabled

services (such as medical transcription, back-office accounting and insurance claims), pharmaceuticals and telecoms.

Global private equity funds have adopted different strategies in India than in Europe and the US. While in Europe and the US, private equity has tended to be equated with leveraged buyouts, in India it tends to involve acquiring minority stakes in growing companies without taking over their management. Such “growth deals” account for over 80 percent of all private equity transactions in India. But buyout deals may come to overshadow them if the country’s investment policy and regulatory regime are liberalized further in the coming years.

Although growth deals appear less destructive than LBOs, they are still controversial in India.

In 2003, for example, Actis, a UK-based private equity firm, paid \$60 million for 29 percent of equity in state-owned Punjab Tractors Limited (PTL) in the country’s first private equity-backed privatization deal. Although Actis’s subsequent attempt to restructure PTL’s operations was opposed by PTL’s senior management, Actis managed to oust the entire senior management team (including the chair) in 2006 when it brought an Indian shareholder onto the board. In early 2007, Actis sold its 29 percent stake to a strategic investor, Mahindra & Mahindra Limited, for \$144 million. Within three years, in other words, Actis (which was spun off as a management buyout from the UK government’s Commonwealth Development Corporation [CDC] in 2004, with CDC remaining its largest investor) had cornered a handsome profit of about 2.4 times its initial investment.

In the first half of 2007, some of the biggest private equity investments in India were in the financial sector, particularly in stock market broking and microfinance businesses, even though the banking and insurance sectors have not yet been fully opened for foreign investments.

To private equity funds, microfinance business in India offers new avenues of profit-making since interest rates range from 30 to 60 percent

and repayment rates are over 95 percent, far above commercial lending. Unlike commercial banking, microfinance institutions (MFIs) are not under regulatory oversight. Also the microfinance business is not considered sensitive to swings in global economic cycles.

Several private equity and hedge funds have invested substantial money in SKS Microfinance, the largest MFI in India which launched an Initial Public Offer (IPO) in mid-2010. According to media reports, the original promoters and private equity funds have sold part of their stake in SKS Microfinance to a hedge fund thereby making a 12-fold profit even before an IPO.<sup>6</sup> This shrewd act by promoters and top management not merely raises doubts about their long-term commitments but, more importantly, questions the real motives of promoters who have become instant millionaires while their borrowers remain desperately poor.

The massive investments by private equity firms have ignited a debate about the ethics and social objectives of microfinance institutions in India. There are strong concerns that private equity funds in their quest for quick returns will weaken the social objectives of microfinance institutions.

### **Sovereign Wealth Funds**

A sovereign wealth fund (SWF) is a large pool of assets and investments owned and managed – directly or indirectly – by a national or state government. It may be funded by foreign exchange (forex) reserves, commodity exports, the proceeds of privatizations or fiscal surpluses. SWFs have been set up to diversify and improve the return on a country's foreign exchange reserves or commodity revenues, and to protect the domestic economy from fluctuations in international commodity prices.

It would be a mistake, however, to consider SWFs as a homogeneous group because their key characteristics – sources of funds, governance structures, operations, investment patterns, objectives, and legal and institutional structures – are hugely divergent.

Like central banks, SWFs deploy surplus forex reserves; but since SWFs

are set up to diversify investment, they undertake long-term investments in illiquid and risky assets, whereas central banks typically undertake short-term investments in low-yielding liquid assets, such as government securities and money market instruments.

At present, there are more than 50 SWFs in the world. According to JP Morgan Research, 39 percent are located in the Middle East and 38 percent in East Asia. Since 2005, more than 10 new SWFs have been established as a result of record commodity prices leading to rapid accumulation of foreign reserves. South Korea launched its SWF in 2005 with \$20 billion in assets; China Investment Corporation (CIC) in 2007; and Russia's National Wealth Fund in 2008. Other developing countries including Brazil, Bolivia, India, Japan and Thailand have also expressed interest in setting up a SWF in the near future.

Of the world's top 20 sovereign wealth funds, 14 are funded from commodity revenues, predominantly from oil and gas exports but some from metals and minerals (such as Russia's Reserve Fund or Chile's Social and Economic Stabilization Fund). The revenues are generated in a variety of ways, including profits made by state-owned companies, commodity taxes and export duties. Non-commodity SWFs are largely funded by transferring assets from official foreign exchange reserves, although some are based on fiscal surpluses, proceeds from the sale of state-owned enterprises to the private sector, and direct transfers from the state budgetary resources.

Unlike private equity and hedge funds, SWFs have fared better in post-crisis period. Higher oil prices in the first half of 2008 raised the kitty of commodity SWFs even though their investments in Western banking system witnessed considerable paper losses. The Norwegian SWF, for instance, suffered huge losses on its equity portfolio due to market meltdown. Nonetheless, most private and official sources estimate that SWFs across the world manage assets worth around US\$3 trillion, equivalent to almost half the world's foreign exchange reserves.

There is no denying that SWFs do own more assets than hedge funds and private equity. But this comparison misses an important point: both hedge funds and private equity are heavily leveraged, increasing their actual financial prowess.

### **Excessive Reserves, Global Imbalances and SWFs**

Pre-crisis, developing countries were accumulating higher forex reserves with myriad motives. First and foremost has been to protect their national economies from any sudden flight of capital, a phenomenon that triggered the Southeast Asian financial crisis back in 1997. This crisis strengthened the resolve among many central banks both within and outside Asia to build up their official foreign exchange reserves so as to protect their national economies from any future volatile capital flows and to prevent a reoccurrence of the Asian financial crisis.

Some developing countries also built up large stocks of reserves to defend themselves against foreign investors, particularly to defend their economies from speculative attacks on their currencies. Others build up higher levels of forex reserves as an insurance policy against having to rely on IMF-supported bailout programs that come with strict conditionalities, such as cuts in social spending and privatization of state-owned companies.

However, large forex reserves pose new challenges and risks. They put pressure on a country's exchange rate so that the currency appreciates, negatively affecting the competitiveness of exports. Excessive reserves could induce asset price bubbles and higher inflation by way of an excessive money supply.

There are fiscal costs as well, as the authorities may lose control of monetary policy. Central banks typically undertake short-term investments in low-yielding liquid assets such as US treasury bills and bonds; the financial returns on these money market instruments are meager – approximately 1 percent in the past 60 years, according to Deutsche Bank Research.<sup>7</sup> In contrast, the equivalent real return on a diversified portfolio of 60 percent stocks and 40 percent bonds has been until recently almost 6 percent.<sup>8</sup>

Since mid-2008, the sharp depreciation of the US dollar in relation to other major currencies has made investments in dollar-denominated money market instruments even more unattractive. Hence state authorities and central banks are seeking alternative investment opportunities.

Sovereign wealth funds have become an obvious choice for diversifying investments and maximizing returns over the long run. By establishing SWFs, countries can also try to conserve some wealth for future generations (although as with all savings, they could also lose wealth and value if markets and/or economies collapse).

From the perspective of commodity exporting countries, SWFs act as a buffer against volatile commodity prices. Since oil, gas, copper and other commodities are non-renewable and finite, commodity exporters also view SWFs as a means of converting non-renewable assets into financial assets for future generations.

Massive global imbalances in global trade have also played an important role.<sup>9</sup> China, Japan, South Korea, Singapore and Hong Kong have been running persistent trade surpluses for many years as a result of their rapidly growing exports. Other countries, however, are running large current account deficits, particularly the US, UK, Italy and most Eastern European countries.

Although the trade surplus of Asian economies have been reduced due to the crisis, current account imbalances are likely to persist in the coming years in the absence of any international policy coordination.

### **Do SWFs Pursue Non-Commercial and Strategic Objectives?**

Pre-crisis, SWFs had come under severe criticism from the Western world for their alleged political and non-commercial objectives.<sup>10</sup> Post-crisis, however, it is becoming clear that the overwhelming majority of sovereign funds are passive investors.

In the rare cases where SWFs have made direct investments, they have

not sought controlling interests or active roles in the management of invested companies, as private equity investors do. Even the large-scale direct investments made by SWFs in US and European banks during 2007-08 were minor in terms of bank ownership and did not come with any special rights or board representation.

The FDI component of all SWF investments is also minimal. According to UNCTAD, FDI by SWFs was a mere \$10 billion in 2007, accounting for just 0.2 percent of total SWF assets and only 0.6 percent of total global FDI flows.<sup>11</sup>

SWFs are typically patient investors with long-term investment horizons. Since they have no explicit liabilities, they can remain committed to their investments in the hope of booking higher returns in the future. Also their funding sources tend to be fairly stable, which makes them less sensitive to market volatility. Given their stable funding sources, SWFs are able to go against market trends, as witnessed during the financial crisis. They bought stakes in UBS, Citigroup, Merrill Lynch and Credit Suisse when credit default swap (CDS) spreads<sup>12</sup> were very high. The higher the CDS spread, the higher the perceived risk.

By injecting billions of dollars into ailing Western banks, SWFs acted as counter-cyclical investors and enabled banks to continue their business. In fact, SWFs have suffered significant paper losses on their investments in Western banks and private equity funds, because the value of their stakes has plummeted when the financial crisis spread globally.

There is no denying that SWFs should be transparent and publicly disclose their asset size, investment portfolio and returns. But the demand by the West for increased SWF transparency lacks credibility given the poor levels of transparency and governance standards amid their own big private investors. Singling out SWFs for their opaqueness but overlooking similar (or even greater) levels of secrecy and unaccountability enjoyed by hedge funds, private equity funds, investment banks and rating agencies exposes the double-standards adopted by Western policymakers.

In principle, all financial institutions (public or private) should be transparent. SWFs need to become more transparent and accountable to their legislatures, public institutions and citizens in both home and host countries.

In October 2008, IMF led International Working Group of Sovereign Wealth Funds (IWG) published 24 voluntary Principles, popularly known as Santiago Principles, to regulate the investments of SWFs. In 2009, International Forum of Sovereign Wealth Funds was also established to oversee the implementation of Santiago Principles.

However, the growing involvement of some prominent sovereign wealth funds (such as Qatar's Investment Authority and Abu Dhabi's Mudabala) in private equity and hedge funds business is a matter of concern as such financing can pose potential market risks.

Unlike private equity and hedge funds, the impact of financial crisis on SWFs was modest. The assets under management of SWFs fell by about 3 percent in 2009.

During the financial crisis, France launched a Euro 20 billion SWF in 2009 with the ostensible aim of protecting national strategic companies from "foreign predators" – the very accusation leveled at sovereign funds from Asia and the Middle East. This is despite the fact that the objective conditions for establishing a SWF – higher current account surpluses and strong basic commodity exports – are missing in France.

### **Should India Establish a SWF?**

Since 2006, the Indian government has shown keen interest in establishing a sovereign fund. The preconditions for establishing a sovereign fund are lacking in India. Unlike China and other East Asian countries, India has been running persistent current account deficits. Its current account deficit touched \$29.8 billion in fiscal 2009 as against \$15.7 billion in fiscal 2007.

Unlike the Middle East, India does not have any dominant exportable



commodity (such as oil or gas) so as to generate significant surpluses. It continues to be a huge net importer of oil and gas. The country's current account deficit is widening despite steady growth in software services exports and a rise in workers' remittances from overseas Indians.

Its persistent current account deficits have been financed by large capital inflows in the form of portfolio investments and other volatile capital flows that are subject to capital flight. Given the overriding presence of volatile capital flows in India's forex reserves, coupled with vulnerability to external shocks, it would be erroneous to consider its foreign exchange reserves (\$280 billion) as a position of strength.

External debt has been rising steadily for the past few years on account of higher borrowings by the Indian companies and short-term credit. Besides, India also runs a perennial fiscal deficit.

### **A Structural Shift?**

In many important ways, the rise of SWFs represents a marked shift away from market capitalism towards state capitalism. This trend should be seen in the wider context of several Latin American countries (such as Venezuela and Bolivia), Russia and China increasing state control over strategic resources, particularly oil and gas.

At the ideological level, the rise of state-owned SWFs fundamentally challenges the ideological underpinnings of the free-market policies promoted under the banner of the Washington Consensus.<sup>13</sup> It questions the Anglo-Saxon economic model based on minimal state intervention and promotion of private enterprise.

But as the financial crisis has amply demonstrated, the Anglo-Saxon model of unrestrained markets has lost its credibility. This is highly significant because the international economic order has been deeply embedded in this economic model since the 1980s. It is in this wider context that the phenomenon of SWFs needs to be situated.

## Hedge Funds

In simple terms, a hedge fund is a private investment partnership wherein investor assets are pooled for the purpose of investing in a variety of securities and derivatives. In fact, the term “hedge fund” is a misnomer because a large number of hedge funds do not hedge against risk at all.

Hedge funds are usually short-term investors and more sensitive to volatility in financial markets. They not only invest at a breathtaking speed but can also pull their money out quickly if performance or market conditions deteriorate.

By effectively using the existing loopholes in the regulatory system, many hedge fund managers structure the fund in such a way that they do not come under the purview of regulatory authorities. They are not required to publicly disclose data on their financial performance and transactions. The majority of hedge funds are registered in offshore tax havens (such as the Cayman Islands and Bermuda) to avoid regulation and tax liabilities. But it is important to note that they are predominantly managed from onshore locations such as New York and London. The US is the largest management centre of hedge funds.

In contrast to SWFs, hedge funds can easily gain large positions in financial markets with the help of leverage and derivatives. There is no limit on the amount of leverage hedge funds can use or the size of any one investment.

The hedge funds have closer financial ties with investment banks. Through prime brokerage relationships, the hedge funds get a number of financial, administrative and operational services by investment banks. Prime brokers usually have knowledge of hedge fund’s positions but nowadays hedge funds often use more than one prime broker in order to not reveal their full positions to prime brokers. Table 2 provides a list of banks that were bailed out in the US and Europe during 2007-09 and their relationships with hedge funds for prime brokerage and other services.

Table 2: The Relationships between Bailout Banks and Hedge Funds

Bailed Company	Bailout Country	Total	Bailed Bank - Fund Relationships			
			Prime Broker	Custodian	Investment Advisor	Other
AIG	US	124	13	22	48	36
Allied Irish Bank	Ireland	77	1	25	4	47
American Express	US	26	-	5	16	5
Bank of America	US	851	481	342	17	10
Bank of Ireland	Ireland	117	11	69	3	34
Bank of N York Mellon	US	624	44	232	74	268
BNP Paribas	France	419	36	230	28	119
Boston Private Fin.	US	4	-	4	-	-
Capital One Fin.	US	2	-	2	-	-
Citigroup	US	982	226	225	18	507
City National	US	2	-	2	-	-
Comerica	US	99	7	92	-	-
Commerce N. Bank	US	2	-	2	-	-
Commerzbank AB	Germany	37	10	22	1	3
Credit Agricole	France	309	9	69	142	73
Dexia	Belgium	297	19	117	66	88
Fortis	Belgium	1173	78	480	54	559
Goldman Sachs	US	2025	1052	731	9	229
JP Morgan Chase	US	1691	680	747	61	197
Lloyds TSB	UK	3	-	3	-	-
Mercantile Bank	US	1	-	1	-	-
Morgan Stanley	US	1938	1130	764	6	37
Northern Trust	US	350	34	112	-	204
PNC Financial S.G.	US	458	8	119	6	321
Royal Bank of Scotland	UK	65	3	-	9	-
Societe Generale	France	500	-	30	9	25
State Street	US	262	15	122	20	104
Sun Trust Banks	US	8	-	8	-	-
Swedbank	Sweden	15	1	8	4	2
U. S. Bancorp	US	9	1	8	-	-
UBS	Switzerland	1075	443	298	92	215
Wells Fargo	US	35	3	24	4	-
WestLB	Germany	4	-	-	4	-

continued on next page...

Country Totals	Belgium	1470	97	597	120	647
	France	809	9	99	151	98
	Germany	41	10	22	5	3
	Ireland	194	12	94	7	81
	Sweden	15	1	8	4	2
	Switzerland	1075	443	298	92	215
	UK	68	3	3	9	0
	US	9493	3694	3564	279	1918
<b>Grand Total</b>		<b>13584</b>	<b>4305</b>	<b>4915</b>	<b>695</b>	<b>3083</b>

Source: Robert W. Faff, Jerry T. Parwada and Kian Tan, *Were Bank Bailouts Effective during the 2007-2009 Financial Crisis? Evidence from Counterparty Risk in the Global Hedge Fund Industry*, February 12, 2010 (Available at SSRN: <http://ssrn.com/abstract=1493004>).

The large positions by hedge funds pose risks not only to their investors but also to the stability of the financial system. Some prominent examples of hedge fund failures include Long-Term Capital Management<sup>14</sup> (LTCM) in 1998, Amaranth Advisors<sup>15</sup> in 2006 and two in-house Bear Stearns funds in 2007. The collapse of LTCM brought the Russian financial crisis to the doors of Wall Street.

Pre-crisis, total investable assets by hedge funds exceeded \$6.5 trillion.<sup>16</sup> In certain asset classes, they were the dominant investors and traders. According to 2007 data from a US based consulting firm, Greenwich Associates, hedge funds were the biggest source of trading volume in interest-rate derivatives accounting for 30 percent of total US trading volume.<sup>17</sup> Hedge funds also constitute approximately 30 percent of all US fixed income security transactions, 55 percent of US activity in derivatives with investment-grade ratings, and more than 40 percent of US leveraged loan trading volume.<sup>18</sup>

The financial crisis has dramatically shrunk the hedge fund industry. The fall in equity markets and squeeze in credit markets pushed hedge funds to liquidate positions to meet margin and redemption calls. Several investment banks and prime brokers which used to provide financing to hedge funds curtailed their funding because of major restructuring amongst prime brokers.

The unraveling of Madoff fraud in 2008 further damaged the reputation of hedge funds industry. With the result, gross assets under management by hedge funds declined by nearly two-thirds to \$2.4 trillion in 2008.<sup>19</sup> Post-crisis, it has been estimated that nearly 1000 hedge funds (out of a total 10500) have closed down.

Although the recovery of equity markets in 2009 saw improvements in the performance of hedge funds, yet their commanding influence in global financial markets has weakened.

Will the crisis lead to ultimate demise of hedge fund industry? No denying that hedge fund industry's financial clout has declined considerably but it can quickly rebound as commitments by institutional investors have not waned. Institutional investors are usually patient investors with long-term investment horizons and do not quickly redeem assets. The hedge funds will remain an important part of global financial landscape, albeit with a lower asset base.

In the coming days, the hedge fund industry can also tap resources from sovereign wealth funds to overcome liquidity problems. After withdrawing from China, India, Mexico and other developing countries in the wake of global financial crisis, there are signs of hedge funds returning to these countries (particularly in equity markets) since mid-2009.

## Notes

1. In 2007, McKinsey Global Institute called four financial actors – investors from oil-exporting countries, Asian central banks, hedge funds and private equity firms – the “new power brokers” because of their growing size and ability to shape global financial markets.
2. “The New Kings of Capitalism,” *The Economist*, November 25, 2004.
3. In April 2005, during the national election campaign in Germany, Franz Muntefering, then Chair of the Social Democratic Party (SPD), described private equity firms as “locusts.” He subsequently published a “locust list” of companies that he circulated within the SPD.
4. Service Employees International Union, *Behind the Buyouts: Inside the World of*

- Private Equity*, April 2007, p. 10 (<http://www.behindthebuyouts.org/buyout-industry>).
5. Peter Morris, *Private Equity, Public Loss?*, Center for the Study of Financial Innovation, 2010.
  6. ET Bureau, “SKS Microfinance bosses unload shares ahead of issue,” *The Economic Times*, March 31, 2010.
  7. Steffen Kern, *Sovereign Wealth Funds: State Investments on the Rise*, Deutsche Bank Research, September 10, 2007, p. 5.
  8. *Ibid.*
  9. This argument is well emphasized in John Gieve, “Sovereign Wealth Funds and Global Imbalances,” speech delivered at the Sovereign Wealth Management conference, London, 14 March 2008 ([www.bankofengland.co.uk/publications/speeches/2008/speech339.pdf](http://www.bankofengland.co.uk/publications/speeches/2008/speech339.pdf)).
  10. For detailed analysis, see, Kavaljit Singh, *Sovereign Wealth Funds: Some Frequently Asked Questions*, The Corner House, 2008 (<http://www.thecornerhouse.org.uk/pdf/briefing/38SWFFAQs.pdf>).
  11. UNCTAD, *World Investment Report 2008: Transnational Corporations and the Infrastructure Challenge*, 2008, p. 21.
  12. A credit default swap (CDS) is a derivative (an asset whose value depends on or is “derived from” the price of another underlying asset) that provides cover if a loan or a bond defaults. Although often described as “insurance,” CDSs are in effect bets on the credit-worthiness of a company. For more information, see Nicholas Hildyard, *A (Crumbling) Wall of Money: Financial Bricolage, Derivatives and Power*, The Corner House, October 2008 (<http://www.thecornerhouse.org.uk/summary.shtml?x=562658>).
  13. The term “Washington Consensus” initially referred to reforms promoted in developing countries by Washington based institutions such as the International Monetary Fund, World Bank and the US Treasury Department, but came to be associated more generally with market fundamentalism, particularly an expanded free market and constraints upon the state.
  14. LTCM was a US hedge fund considered to be “the Rolls Royce of hedge funds.” It was set up in 1994 and had returns of over 40 percent in its initial years. With a capital base of \$4 billion, LTCM had balance sheet assets worth \$125 billion, a leverage of more than 30 times. Its off-balance sheet exposure had a notional value of \$1.2 trillion. During one month in 1998, however, it suffered a 44 percent fall in its net asset value when the financial markets unraveled after Russia defaulted on its debt. Its near collapse triggered financial problems in the well-known and established financial institutions that had lent money to LCTM. In September 1998, the US Federal Reserve organized a rescue of LCTM. The fund was closed

down in early 2000. See Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management*, Fourth Estate, London, 2002.

15. Amaranth Advisors LLC managed some \$9 billion in assets, when it collapsed in September 2006 after losing some \$6 billion in one week on natural gas futures – the Amaranth trader had bet half the firm’s assets that prices would continue to rise, but they didn’t. Amaranth’s cash losses were significantly larger than the \$4 billion lost when LCTM went bust in 1998, but it had not borrowed as much, meaning that its collapse had less impact on other financial institutions.
16. It includes assets under management, borrowings and off-balance sheet leverage through derivatives positions. Source: McKinsey Global Institute, *The New Power Brokers: How oil Asia, Hedge Funds, and Private Equity are faring in the Financial Crisis*, July 2009, p.13.
17. Greenwich Associates, “In US Fixed Income, Hedge Funds are the Biggest Game in Town,” August 30, 2007.
18. Ibid.
19. McKinsey Global Institute, op. cit., p.14.

# 5

## **Financial Derivatives and the Globalization of Risk**

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

Trading in derivatives related to raw minerals and goods dates back to 17th century, as witnessed in the case of tulip bulbs in Holland and rice in Japan. The financial derivatives began in 1972 with currency trading. Stock-index futures trading began in 1982, and trading in interest-rate futures commenced in 1988.

### **The Exponential Growth**

Derivatives market grew exponentially during the 1990s and quintupled between 2002 and 2008. Interest rates instruments dominate the world of financial derivatives, accounting for 71 percent of global notional value. At present, financial derivative markets are not restricted to developed countries alone. A number of developing countries allow trading in financial derivative instruments.

Trading in financial derivatives products is also distance-less and borderless. Financial derivatives are either transacted over-the-counter (OTC) or traded at exchanges. The global OTC derivatives trading is concentrated in the UK and US. The UK alone accounted for 43 percent of global turnover in 2007. There are specialist exchanges (e.g., London International Financial Futures Exchange) in which financial derivatives



are traded. However, in recent years, the value of OTC instruments has increased sharply as compared to exchange-traded instruments. While exchange-traded instruments are relatively regulated, OTC contracts are informal agreements between two parties and therefore carry heavy risk.

### **The Risks**

While financial derivatives are supposed to help reduce risk, they have become one of the biggest sources of volatility and instability in the global financial markets. Derivatives pose additional risks because many of the contracts are highly speculative thereby increasing the chances of heavy losses if a bet goes sour. Speculators play an important role in the trading of financial derivatives. They keep buying and selling contracts depending on their perceptions of the movements of financial markets. US investor Warren Buffett famously described credit derivatives in 2002 as “financial weapons of mass destruction.”<sup>1</sup>

The risks posed by derivative markets are twofold: firm specific risks and systemic risks. Since derivatives are highly leveraged, a small change in the interest rates, exchange rates and equity prices can cause huge financial losses to the firm. Depending on the extent of integration with the larger financial system, firm specific risk can easily spread to the entire system.

Since financial derivatives are highly leveraged instruments, a slight mishandling of trading can lead to huge losses. Secondly, there are serious weaknesses in the internal control and risk management systems within the banks and institutions involved in financial derivatives. Lastly, and perhaps more importantly, regulatory and supervisory authorities have lagged behind in anticipating the inherent risks involved in the derivatives trading particularly in the opaque OTC derivative markets.

The OTC derivatives market is a potential source of systemic risk because of high levels of concentration in a few big dealer banks. In terms of gross notional amounts, the 10 largest dealers account for 90 percent of trading volume. In the US, the five biggest banks account for more than 90 percent of total trading volume.

Such high levels of concentration have raised concern among policymakers about counterparty credit risk in the CDS market. Large exposures to one another among key market participants increase the repercussion effects of shocks if one of the key market players were to default on its obligation. A default by one large financial institution could lead to a chain reaction leading to a market collapse.

Since many derivatives are off-balance sheet items, the ability of market participants to assess the risks faced by the counterparties is hampered. Such lack of disclosures leads to counterparties having no idea about the financial health of the firm with which they are dealing.

### **Recent Derivatives Disasters**

Notwithstanding the brief history of financial derivatives, they have played havoc in the world financial markets.<sup>2</sup> In January 2008, Societe Generale, a leading European bank, suffered a loss of \$7.2 billion on account of fraudulent futures trading. In April 2010, US authorities filed a civil suit against Goldman Sachs for defrauding investors by creating risky derivatives or CDOs for its short-selling client Paulson & Co.

Although attention is often paid to the role of “rogue trader” for incurring huge losses (e.g., Jerome Kerviel of Societe Generale, Leeson of Barings and Iguchi of Daiwa), but underlying factors behind many of these financial disasters have been largely ignored.

The role played by derivative instruments, particularly OTC instruments, in the exacerbation of global financial crisis is well documented. The financial innovation based on credit derivatives was at the heart of the crisis. The synthetic CDOs, under the scrutiny of regulators in the aftermath of crisis, were essentially driven by “regulatory arbitrage” and had little or no social value.

To some extent, the financial crisis has put a brake in the rapid growth of derivatives industry. The notional outstanding value of OTC derivatives contract fell to \$592 trillion at end-2008 from its peak of \$684 trillion in

June 2008. One of the main reasons behind the decline was the movement of contracts from OTC markets to centralized clearing. The notional amounts reveal the overall market size while the gross market values (\$21.6 trillion in December 2009) reveal actual amounts at risk.

In 2008, the notional value of credit default swaps (the most popular form of credit derivatives) reached \$64 trillion. During the crisis, it declined to \$38 trillion in 2009. The net exposure of major CDS dealers was \$2.9 trillion in June 2009.

The global financial crisis has amply demonstrated the need for strict regulation of complex and opaque financial derivative markets. Concerted efforts should also be made to increase transparency and improve counterparty risk management.

The multi-trillion credit default swaps market has been operating for years with no public disclosure or legally enforced reporting requirements. A large part of CDS transactions belongs to naked CDS – where an investor takes out insurance on bonds without actually owning them. Since naked CDS are purely speculative instruments and have no social benefit, there are compelling reasons for banning them.

Even though foreign exchange derivatives were introduced in India in a restricted manner, several instances of fraudulent selling of exotic currency derivatives by banks to small and medium-sized exporters have come to notice (see Box 5). These instances have ignited the debate to what extent financial derivatives should be allowed in India.

### Notes

1. “Warren Buffet on Derivatives,” (<http://www.fintools.com/docs/Warren%20Buffet%20on%20Derivatives.pdf>).
2. For a detailed account of financial disasters associated with derivatives, see Kavaljit Singh, *Taming Global Financial Flows: Challenges and Alternatives in an Era of Financial Globalization*, Zed Books, 2000.

# 6

## **Global Financial Crisis and India**

Before examining the impact of global financial crisis on Indian economy, some key features of India's financial system are briefly described below.

The Indian financial sector is dominated by bank intermediation despite rapid growth of capital markets since 1991. The share of banking assets in India's financial sector assets is around 75 percent. Within the banking sector, commercial banks are the dominant players, accounting for almost 60 percent of total assets. The state-owned banks constitute nearly 70 percent of total commercial banking assets. The private sector banks own 23 percent and the rest 7 percent are owned by foreign banks. In addition, there are cooperative and rural banks serving local markets. The other major segments of the financial system include non-bank financial companies (NBFCs), development finance institutions and microfinance institutions.

Since the launching of liberalization and globalization policies in 1991, a series of important developments have taken place in the Indian banking sector, ranging from a liberalized regime for the entry of foreign and private banks to divest in state-owned banks to interest rate deregulation to dismantling of developmental financial institutions.

The stated objective of banking liberalization has been to make banks more competitive, efficient, productive and profitable. Several official committees have recommended opening up of India's banking sector on the grounds that the entry of foreign banks would enhance competitive efficiency of the banking sector and would encourage domestic banks to adopt "best practices" and new technology.

The processes involved in the banking sector liberalization in India are very dynamic and complex. The pressure to open up the banking sector in India has come from various sources (domestic and foreign). Since 1991, the entry of foreign banks has been gradually liberalized.

Unlike UK which follows a principles-based regulatory system, India follows a rules-based regulatory system with prescriptive norms on how banks and financial institutions should operate their businesses. Under the Banking Regulation Act of 1949, the Reserve Bank of India (RBI), country's central bank, has the power and responsibility to regulate and supervise all banks. No bank can carry out business in India without a license issued by the RBI. The RBI also regulates forex, interest rate, credit markets and derivatives.

On the other hand, equity markets, insurance companies, housing finance companies, mutual funds, pension funds, stock broking companies, merchant banking companies and venture capital funds are regulated by the respective sectoral regulators.

Since India follows a multi-regulatory regime, a High Level Coordination Committee on Financial Markets (HLCCFM) consisting of Finance Ministry, RBI and sectoral regulatory authorities was formed in 1999 to deal with inter-regulatory issues arising in the banking, insurance and equity markets. Unfortunately, the operations of HLCCFM are not in the public domain which makes it difficult to assess its performance so far. In February 2010, the Finance Minister proposed the creation of a Financial Stability and Development Council (FSDC) which will replace HLCCFM. The proposed FSDC will not only deal with inter-regulatory issues but, more importantly, will oversee financial stability and macro-prudential supervision.

### **The Impact of Crisis**

The initial impact of the sub-prime mortgage crisis on the India's banking sector was rather muted given the fact that Indian banks had almost negligible exposure to sub-prime mortgages and associated financial derivatives.

However, post-Lehman period, there was a massive sell-off in Indian equity markets as foreign institutional investors (FIIs) and hedge funds

quickly liquidated their positions due to global deleveraging. Given the dominant position of FIIs and portfolio investors in Indian secondary markets, the stock market indices fell more than 50 percent. With the result, there were large capital outflows in the last quarter of 2008.

The capital inflows were drastically lower in 2008-09. Unlike foreign direct investment, trade credits and external commercial borrowings by domestic private sector suffered substantial decline due to global liquidity squeeze (Table 3). All these developments put downward pressures on the Indian Rupee and exacerbated volatility in the foreign exchange market.

To some extent, the financial crisis also increased the risk aversion in Indian banking system as some banks, particularly foreign banks, reduced domestic lending.

However, the impacts of global financial crisis were more visible in the real economy. The decline in demand for exports from US, European and Asian countries had an adverse impact on India's exports and industrial performance. In particular, goods trade witnessed a sharp decline. Contraction in global trade finance markets also adversely impacted the

**Table 3: Trends in Capital Flows to India (\$ billion)**

Component	Period	2007-08	2008-09
Foreign Direct Investment	April-February	27.6	31.7
Foreign Institutional Investors (net)	April-March	20.3	-15.0
External Commercial Borrowings (net)	April-December	17.5	6.0
Short-term Trade Credits (net)	April-December	10.7	0.5
Total Capital Flows (net)	April-December	82.0	15.3
<b>Memo:</b>			
Current Account Balance	April-December	-15.5	-36.5
Valuation Gains/Losses on Forex Reserves	April-December	9.0	-33.4
Foreign Exchange Reserves (variation)	April-December	76.1	-53.8
Foreign Exchange Reserves (variation)	April-March	110.5	-57.7

Source: Reserve Bank of India.

country's exports. For the first time since 2001, India's export growth faced a contraction in 2008-09. While inward remittances from migrant workers remained stable.

The real GDP growth was 6.9 percent in the first three quarters of 2008-09, as compared to 9.0 percent in the corresponding period of 2007-08. The growth in industrial production declined to 2.8 percent in 2008-09 (April-February) from 8.8 percent in the corresponding period of 2007-08.

**Box 4****The Foreign Exchange Market in India**

India's foreign exchange market has witnessed significant growth since the late 1990s. The daily average turnover has increased from \$5 billion in 1998 to more than \$50 billion in 2008. Much of the increase in trading has come from derivatives segment of the market in which foreign exchange swaps account for largest share followed by forwards and options. Since 2008, exchange-traded currency futures have been introduced in India.

According to Triennial Survey of Foreign Exchange and Derivatives Market Activity conducted by the Bank for International Settlements, even though the share of India in global foreign exchange market turnover was merely 0.9 percent in April 2007, the rate of increase during April 2004-April 2007 was the highest amongst the 54 countries covered in the Survey. The rapid growth in forex trading is the outcome of removal of restrictions on both current and capital accounts over the years. Nowadays large transactions in forex markets emanate from capital account transactions.

Post-Lehman period, not merely the average daily turnover in Indian forex markets declined but also a considerable amount of volatility was observed. Like other emerging market currencies, the Rupee also witnessed a sharp downward trend. To a large extent, existing capital controls helped in maintaining liquidity in currency markets. The RBI also undertook several unorthodox policy measures to restore stability in forex markets.

In order to arrest decline in economic growth, both the central government and the central bank undertook several unorthodox policy measures. Post crisis, the central government announced several fiscal stimulus packages while the RBI implemented expansionary monetary and counter cyclical regulatory measures in the banking sector.

### **Why Resilience in Indian Banking System?**

Despite certain adverse developments in the wake of global financial crisis, Indian banks have not suffered major losses and no government bailouts have been sought. The relative resilience of the Indian financial system to the global financial crisis could be attributed to three key factors.

First, as mentioned above, Indian banks had almost negligible direct exposure to sub-prime mortgages, CDOs and crisis-ridden banks. Only two Indian banks with overseas branches had invested in CDOs involving sub-prime mortgages. Thus, they suffered mark-to-market losses due to widening of credit spreads in financial markets.

Over the years, the asset quality and soundness parameters of domestic banking system have improved significantly. Indian banks generally maintain high levels of capital adequacy ratio. Unlike US and Europe, banks in India are not allowed excessive leverage due to strict regulatory norms. In 2009, the stress tests undertaken by the Committee on Financial Sector Assessment found that the Indian banking system can withstand significant shocks arising from large potential changes in credit quality, interest rate and liquidity conditions.

Besides, the relatively lower presence of foreign banks in India turned out to be a blessing as it minimized the spillover effects of global crisis on the domestic banking system. In highly financially-integrated Central and East European countries, the larger presence of foreign banks made their economies extremely vulnerable to the crisis. These economies experienced a sharp decline in bank credit supply as Western parent banks withdrew funds from their subsidiaries operating in the region.



Second, unlike other emerging markets, Indian economy is not highly integrated into the global economy. The Indian economy is primarily driven by domestic consumption and investment. External demand, as measured by merchandise exports, accounts for less than 15 percent of India's GDP.<sup>1</sup>

India's capital account is not yet fully liberalized. There are several restrictions on cross-border investments and debt flows. There are explicit quantity-based and price-based controls on investment, corporate borrowings and government securities. Capital outflows are permitted under specific conditions and purposes. The originate-to-distribute model of banking is also not widely practiced in India.

The limited opening up of the capital account and financial sector has protected India from external shocks emanating from the crisis. This is despite the fact that powerful lobbies of domestic big business, financiers and economists have been demanding complete dismantling of capital controls.

The demand for full liberalization of capital account is put forward in two recently appointed committees by the government and the Planning Commission: The High Powered Expert Committee on Making Mumbai an International Financial Centre (chaired by Percy Mistry); and the Committee on Financial Sector Reforms (chaired by Raghuram Rajan, former chief economist of the IMF).

**Table 4: Key Indicators of Openness of the Indian Economy (% of GDP)**

Year	Goods Trade	Service Trade	Gross Current Account	Gross Capital Account	Gross Current and Capital Account
1970s	10.0	1.3	12.7	4.2	16.9
1980s	12.7	2.5	17.2	5.4	22.6
1990s	18.8	4.1	26.7	15.1	41.8
2000s (2000-09)	29.4	9.8	45.1	32.8	77.9

Source: Reserve Bank of India.

A section of Indian policymakers still favors full capital account liberalization despite the occurrence of several financial crises in the recent past. The policymakers need to recognize that the greater financial integration will make Indian economy more vulnerable and susceptible to global business cycles.

Third, India's regulatory framework (often criticized in the past as "outdated," "inward looking," and "conservative") acted as a key factor in protecting the domestic banking system from the global financial meltdown.

Much before the onset of global crisis, the RBI had introduced several unorthodox policy measures in the banking system to maintain macroeconomic and financial stability. These measures were aimed at preventing banks and financial institutions from excessive risk taking and containing credit growth and asset bubbles in certain segments. It included strict liquidity requirements, restrictions on leverage and securitizations, and counter-cyclical prudential measures. Some of important policy measures introduced by RBI are listed below:

1. New prudential measures were imposed on banks for their exposures to real estate, housing loans, capital markets and consumer credit. In particular, risk weights and provisioning requirements were substantially increased to contain the boom in real estate and housing loans during 2003-07.
2. Participation in the unsecured overnight money market has been restricted to banks and primary dealers. Higher ceilings have been imposed on their borrowing and lending operations in this market due to inherent systemic risk arising from interconnectedness.
3. Prudential limits have been imposed on banks on their inter-bank liabilities in relation to their net worth.
4. Asset-liability management guidelines have been framed that take notice of both on- and off-balance sheet items.

5. The regulatory guidelines on securitization (issued in 2006) do not allow immediate profit recognition.
6. The regulation and supervision of NBFCs was tightened by reducing regulatory arbitrage vis-à-vis the banking sector.
7. Restrictions were introduced on wholesale foreign currency liabilities intermediated through banks.

The close coordination between RBI and other sectoral regulators also facilitated smooth functioning of financial markets during the crisis.

### **Should India Open Up Banking System?**

To enlarge the presence of foreign banks in the Indian banking markets, RBI had announced a roadmap in 2005 entailing sequencing of banking reform measures in two phases. Starting from April 2009, the second phase of roadmap under which foreign banks were to be given the “National Treatment” has been stalled due to the global financial crisis.

Apart from unilateral liberalization measures, India has been gradually opening up its banking sector due to its commitments made at the WTO and bilateral trade agreements. Under the WTO agreement, India has given commitments to offer 12 new licenses every year to foreign banks. In practice, the number of branches permitted each year to foreign banks has been higher than the WTO commitments.<sup>2</sup>

Banking services liberalization is an important component of India’s bilateral trade agreements with Singapore and Korea. The proposed bilateral agreements with EU, Japan, Australia and ASEAN also contain commitments to open up India’s banking sector.

Several official committees have also recommended opening up of India’s banking sector on the grounds that the entry of foreign banks would enhance competitive efficiency of the banking sector and would encourage domestic banks to adopt “best practices” and new technology.

There is a popular perception that foreign banks perform better than domestic banks (both state-owned and private) on efficiency and productivity levels in India. However, the analysis carried out by RBI suggests domestic banks no longer lag behind their foreign peers on efficiency indicators. On several parameters, state-owned banks outperform both foreign and private banks despite the fact that state-owned banks run a huge branch network in the rural and semi-urban areas and undertake substantial social and developmental banking activities.

The Reserve Bank of India has measured efficiency of different bank-groups in India using both accounting and economic measures.<sup>3</sup> Based on its rigorous analysis, the RBI observed that “ownership has no definite relationship with efficiency.”<sup>4</sup> Nevertheless, in a developing country like India, the pursuit of higher efficiency levels cannot be an end in itself. As observed by T. T. Ram Mohan, “Ever increasing levels of efficiency cannot be the sole objective for the banking sector. We need a level of efficiency that is consistent with other objectives - financial inclusion, development of agriculture and, not least, financial stability.”<sup>5</sup>

In contrast to global standards, India’s provides better access to foreign banks which is characterized by a single class of banking license, no restrictions in setting up non-banking financial subsidiaries, uniform deposit insurance and lower priority sector requirements.

### **Rethinking Large Presence of Foreign Banks**

In India, the much-touted benefits associated with the liberal entry of foreign banks are yet to be materialized. The urban-centric foreign banks largely serve the niche market segments consisting of HNWIs and large corporations in India. Time and again, many foreign banks have demanded removal of priority sector lending requirements and other riders related to social and development banking in India.

Critics have raised several important questions related to the liberal entry of foreign banks in India. Are big international banks going to augment the reach of the banking system to millions of Indians citizens

who do not have access to basic banking services? What extraordinary services foreign banks would provide to serve unbanked Indian people? What specialization and experience do foreign banks have when it comes to providing basic banking services to landless rural workers and urban poor dwellers?

The liberal entry of foreign banks may further constrict the access of banking services in the country: geographically, socially and functionally. Also one cannot expect that big international banks would voluntarily open branches in rural and remote regions of India as part of altruistic motives or corporate social responsibility measures. This anomaly could only be addressed by branch licensing policy and strong regulatory and supervisory measures.

Since a large number of big foreign banks are in the midst of turmoil and financial distress in the aftermath of the crisis, it raises serious questions about their efficiency, “best practices” and state-of-the-art risk management models. The crisis has also exposed the poor corporate governance structures and practices of internationally active banks.

In the light of financial crisis, the agenda of market-driven reforms and large presence of foreign banks should be seriously reconsidered by Indian policy makers. A detailed cost-benefit analysis of the impact of the entry of foreign banks in the Indian banking sector is needed.

### **The Twin Policy Challenges Facing Indian Banking System**

For India, financial inclusion has become a key policy concern given the fact that there are over 500 million citizens who lack basic banking and financial services. Though there is no universally accepted definition of financial inclusion, in simple terms, it means providing affordable services (such as bank accounts, credit, remittance and payment services) to those sections of society who are not part of formal financial system.

Since financial exclusion has strong linkages with poverty, it is predominantly concentrated among the poor and marginalized sections

of society. From an economic development viewpoint, financial exclusion denies opportunities to poor people to come out of poverty. In the case of India, financial exclusion is largely concentrated among landless laborers, small farmers, urban poor, migrants, lower castes, tribal communities, senior citizens and women. In the last two decades, bank lending to agriculture, small-scale industries and other small borrowers have declined considerably.<sup>6</sup>

The track record of foreign banks in promoting financial inclusion has been extremely poor in India. To date, most of bank branches of foreign banks are located in metropolitan areas and major cities where bulk of premium banking business is concentrated. As on June 2008, there were 30 foreign banks operating in India with a network of 279 branches and 765 off-site ATMs. Out of 279 branches, 227 (81.4 percent) were located in metropolitan areas, 50 (17.9 percent) in urban areas and just 2 (0.7 percent) in semi-urban areas. Till 2008, not a single foreign bank had opened a branch in rural India. This is despite the fact that several prominent foreign banks (such as Standard Chartered, BNP Paribas and HSBC) have been operating in India for more than 140 years.

It is equally distressing to note that foreign banks are not serving the poor and low-income people residing in metropolitan and urban areas. There is no regulatory ban on foreign banks to serve the urban poor and low-income people. Rather, India's approximately 190 million urban poor provide a huge untapped market that could be reached by foreign banks. The potential market size cannot be overlooked given the saturation of retail banking markets in the developed countries.

Concerned with the widespread financial exclusion, the RBI launched several policy initiatives since 2005. In November 2005, the RBI advised all banks to make available a basic "no-frills" savings account either with nil or low minimum balances to weaker sections of society. To facilitate "no-frills" accounts, Know Your Customer (KYC) procedures were simplified. Not surprisingly, the overwhelming numbers of "no-frills" accounts have been opened up by the state-owned banks (87 percent as on December

2007), followed by domestic private banks (12 percent). The contribution of foreign banks in opening “no-frills” accounts has been minimal (0.23 percent), even though they control 7 percent of India’s banking assets.

Typically, foreign (and domestic private banks) are averse to provide banking services to the poor people because they find such clients less lucrative. Foreign banks tend to follow “exclusive banking” by offering services to a small number of wealthy clients.

It is well established that not only foreign banks charge higher fees from customers for providing banking services but maintaining a bank account requires substantial financial resources. Several foreign banks have expressed their discomfort in fulfilling the mandatory priority sector lending requirements. Many foreign and private banks would prefer only to have a niche banking model with no riders in terms of social and developmental banking.

### **Managing Off-balance Sheet Exposure**

The other major policy challenge is the rise of off-balance sheet exposure in certain segments of Indian banking system. According to RBI, as end-March 2008, the total off-balance sheet exposure of all commercial banks in India was more than three times the size of their consolidated balance sheet as compared with more than two times at end-March 2007.<sup>7</sup> These exposures are in the form of financial derivatives, letters of credit, financial guarantees, endorsements and underwriting.

However, domestic banks are lagging behind the foreign banks in terms of off-balance sheet activities. Foreign banks with 7 percent share in on-balance sheet assets have almost three-fourths of banking system’s off-balance sheet exposure.

According to RBI statistics, as on March 2008, the off-balance sheet exposure of foreign banks was at 2,830.5 percent of their total assets, followed by new private sector banks (301.8 percent), public sector banks (61.5 percent) and old private sector banks (57.1 percent).<sup>8</sup> Among the

bank groups, foreign banks constituted the largest share (70.8 percent), followed by new private sector banks (15.6 percent) and public sector banks (12.9 percent) in the total off-balance sheet exposure of commercial banks.<sup>9</sup>

The global financial crisis has proved beyond doubt that banks are ultimately accountable for both on- and off-balance sheet liabilities. The banks will have to honor off-balance sheet commitments if their clients fail to do so. The HSBC, for instance, had to shift its \$35 billion liability from “off-balance sheet” status to “on-balance sheet” status in the aftermath of sub-prime mortgage crisis. The technical divisions between “on-balance sheet” and “off-balance sheet” items are largely used by banks to avoid prudential capital requirement norms and diversify their sources of income.

The off-balance sheet items could pose liquidity risk to the banks if not supervised properly. The tendency among some corporations to use derivatives for speculative profits coupled with the lack of disclosure norms pose risks to the banking system. Derivatives such as interest rate swaps are very risky instruments.

In the light of recent incidence of losses suffered by Indian exporters on account of foreign exchange derivative products (an off-balance sheet business) sold by foreign banks and domestic new private sector banks, it is recommended that the central bank should put stringent preconditions for use of such products.

In April 2007, the Reserve Bank of India announced the introduction of credit derivatives in a calibrated manner. The RBI had also issued draft regulatory guidelines on credit default swaps for further discussions. However, the decision to introduce credit derivatives was postponed with the onset of the global financial crisis.

What is worrisome is the current mindset of a section of Indian policymakers still committed to the pre-crisis model based on deregulation, open capital account and market-driven financial system. This is strongly reflected in the recommendations of two official committees: The High Powered Expert Committee on Making Mumbai an International Financial Centre and the Committee on Financial Sector Reforms.



## Box 5

**Exotic Currency Derivatives Trap  
Small Exporters in India**

During 2006-07, the depreciation of the US dollar against most global currencies coupled with rupee appreciation hit the Indian exporters badly. In particular, small and medium-sized exporters located in export zones such as Tirupur, Ludhiana, Panipat and Karur began to lose their competitive advantage due to currency appreciation.

Taking undue advantage of the situation, private and foreign banks aggressively pushed exotic currency derivative products to exporters ostensibly to hedge their losses from a rising Rupee. The unwary exporters entered into derivative contracts largely on the advice of the banks without realizing the potential risks involved in these products. In many instances, the full implications of these risky complex products were not explained to the buyers.

Many buyers of these complex products in Tirupur and elsewhere were small exporters (ex-farmers with little education and awareness to understand these complex products).

Some banks offered sample deals to buyers in order to clinch bigger deals in the future. After gaining the confidence of the exporters, private and foreign banks pushed derivative products which were grossly irrelevant and unsuitable. For instance, banks sold derivative products in multiple, cross-currencies (such as Swiss franc and Japanese yen) despite being fully aware that most Indian exporters bill their exports in US dollars.

Apart from the alleged breach of trust by banks, the currency derivative contracts were also in violation of existing derivative regulations. For instance, regulations allow only those banks with whom exporters have a credit relationship to offer such products. Derivative transactions that do not hedge any underlying exposure are not allowed.

Further, the regulations specify that the value of derivative products should have some relationship with the business turnover

*continued on next page...*

of the export company. In practice, all such regulations were violated by banks while offering derivative products to small and medium-sized exporters. No due diligence was undertaken by the banks to assess the suitability of the derivative product to a small exporter.

However, these speculative contracts went haywire when the Swiss franc and Japanese yen began to rise suddenly against the dollar in early 2008. As a result, several exporters incurred huge losses as their derivative contracts multiplied their foreign exchange risks. The Tirupur-based Plywin Exports, for instance, incurred a loss of Rs.80 million on the currency derivatives sold by ABN Amro Bank.

According to one estimate, total losses suffered by Tirupur-based exporters on account on derivative contracts were above Rs.4000 million, almost the net-worth of all exporters based in Tirupur.

Many exporters have accused the banks for concealing the risk inherent in these contracts. Some exporters have taken the matter to the court alleging that the banks sold them exotic derivatives contracts for purely speculative purposes. The banks too are sitting on the massive piles of non-recoverable debt. The losses are so huge that the banks cannot recover them by even selling the assets of the export firms.

Some small-sized exporters are on the verge of closure with serious negative implications on employment and exports. In Tirupur, there are over 6,250 factories, which provide direct employment to 350,000 people (mostly rural women) and indirect employment to about 150,000 people. After this incident, small exporters have become wary of such exotic derivative products.

Both the committees have recommended the significant liberalization of capital account, an inflation targeted monetary policy, and a shift from a rule-based to a principles-based regulatory architecture. In its report submitted in 2008, the Committee on Financial Sector Reforms also recommended freeing up branch licensing policy for foreign banks and dismantling of directed credit regime. In the light of financial crisis, it remains to be seen how far the RBI and government will implement the recommendations of these two official committees.

The Indian political establishment also remains non-committal to the imposition of a Tobin type tax on capital inflows despite considerable support in policy and intellectual circles internationally.

The sharp recovery in Indian equity markets since May 2009 raises serious concerns about the creation of new asset bubbles. Thus, it is imperative that the Indian authorities should reconsider their liberal approach towards such volatile capital flows.

### Notes

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# 7

## **Guiding Principles for Building a Stable Global Financial System**

Post-crisis, few could disagree that the present global financial system (or rather “non-system”) needs far-reaching and comprehensive reforms. In fact, the demand for reforming the global financial system antedates to the eighties, when the debt crisis was at its peak. Since then, several policy frameworks and measures advocating reforms of the international financial system have been proposed at various forums.

In the aftermath of Southeast Asian financial crisis, policy discussions were initiated at the global levels to establish a “new international financial architecture.” In response, a number of progressive economists, civil society and political groups had also outlined specific measures towards building a more transparent, rule-based and stable global financial system.

Since the tenets of the Washington Consensus held sway in those times, the G-7 countries, IFIs, and private sector lobby organizations outrightly rejected any restrictions on financial markets and cross border flow of capital. Besides, initiatives on creating a “new international financial architecture” also lost momentum due to rapid economic recovery and building up of forex reserves for self-insurance by Asian economies.

The crisis has given new impetus to the demands for reforming the global financial system. The crisis has highlighted that financial markets are inherently unstable and market failures have huge economic and social costs. There is not a single country in the world which has not been affected by contagion effects of the crisis through financial or trade channels.

Because of the crisis, the intellectual climate is shifting away from a pure market-based to a more regulated financial system. Also one cannot ignore the fact that the bargaining power of big banks and financial institutions has relatively weakened following the crisis. These developments

offer new opportunities to broaden the reform agenda of the global financial system.

Several international efforts by both official and non-official bodies are underway to fix the global financial system. A number of policy proposals are under discussion at G20, the FSB and the BCBS. Some policy proposals aim at repairing the cracks in the present system (such as greater market transparency and higher capital adequacy norms) while others suggest a fundamental redesigning of the entire financial system. By and large, there is a growing consensus that a stable international financial system will make the world less vulnerable to frequent financial crises.

Some of the recent prominent reports on reforming financial system include the UN Report chaired by Joseph Stiglitz (2009), Turner Review (2009), the Geneva Report on World Economy (2009), the de Larosiere Report (2009) and the Group of Thirty Report chaired by Paul Volcker (2009).

A detailed review of the merits and demerits of each report is beyond the scope of this book. However, all these reports recognize the inherent instability of the present global financial system. While there is general consensus on the desirability of reforming the global financial system, there seems to be no unanimity on the nature and content of reforms and their actual implementation. In any case, restructuring of global financial system does not seem to be an easy task, since the obstacles are primarily political in nature, and not academic or administrative.

### **Some Guiding Principles**

Any attempt to restructure the present international financial system presupposes a set of guiding principles under which several specific steps could be initiated to achieve the desired results. In order to rewrite the rules of global financial system, some important guiding principles are outlined here.

**First**, it needs to be reiterated that finance is a means to an end, not an

end in itself. The financial sector exists to serve the real economy, not the other way around. The new global financial system should channel resources into productive activities and promote inclusive development. It should also contribute in greening the world economy.

**Second**, policy makers should recognize that international financial stability is an important global public good. Financial stability at both micro and macro levels should be vigorously pursued even though it may not be an explicit responsibility of central banks and regulatory bodies.

Apart from ensuring sound individual institutions, regulators should also protect and strengthen systemic stability through macro-prudential regulation and oversight. By focusing on systemic risks, macro-prudential response can help in preventing a financial crisis.

**Third**, the crisis has proved that macroeconomic stability, by itself, cannot guarantee financial stability. Financial instability could develop even during a period when there is macroeconomic and price stability.

**Fourth**, financial innovation has drastically transformed the financial system in the last two decades but regulatory response has lagged behind it. Many large financial institutions operate at a global level but are regulated nationally. The growing complexity and interconnectedness of financial markets (for instance, close relationships between banks and hedge funds) need to be properly understood to detect systemic risks.

What is required is a new perspective to look at global financial markets where lightly-regulated entities such as hedge funds, private equity funds and non-banking financial institutions have become powerful in recent years. Within the commercial banking system, off-balance sheet instruments and shadow banking system emerged without any regulatory oversight. The main sources of global financial crisis were those institutions and instruments which were either lightly regulated and/or lightly supervised.

Therefore, an important lesson of the present crisis is that the regulation

framework will need to keep pace with the rapidly changing global financial system.

Although the current emphasis is on regulation, better supervision of financial system is equally important. A regulation is only as good as the quality of its implementation. During the crisis, many problems erupted due to poor implementation of existing regulations. The regulation and supervision should extend to systemically important markets, institutions and instruments.

At the same time, it is also important that issues pertaining regulatory capture and “culture capture”<sup>1</sup> are addressed otherwise regulators and supervisors may keep on serving narrow vested interests of bankers and financiers.

In the developed countries, large, complex and internationally active financial institutions which are considered “too big to fail” and “too systemic to fail” should receive closer regulatory oversight, if breaking them into smaller entities is not politically feasible.

Many internationally active banks played a key role in the rapid transmission of financial shocks across the world. Their funding and liquidity management practices need to be reviewed. The internationally active banks involved in “originate-to-distribute” model need to be brought under strict supervision. In order to avoid regulatory arbitrage, there is a greater need for coordination among agencies both within and across borders.

Further, problems associated with market manipulations such as insider trading, short selling and program trading require better understanding by the national regulatory authorities. Market practices such as dark pools, flash trading and naked short-selling which undermine efficiency and stability should be curbed.

The “flash crash” on May 6, 2010 (when the Dow Jones Industrial Average lost almost 1000 points within minutes) has shown how a single

big trader can wreak havoc in the entire market. To curb excessive volatility in stock markets, regulatory agencies could impose strict measures including margins, price-bands and circuit breakers. Strict penalties should be imposed by supervisors if market players fail to comply with regulations.

**Fifth**, the strategic role of governments and coordination among them to regulate the global financial markets cannot be overstated. Pre-crisis, it was strongly argued that market should be allowed to control itself through self-discipline instead of direct regulatory intervention.

The current crisis has demonstrated that markets have miserably failed to control their own functioning, while the cost of market failure has been borne by society. Countries that were following market-led financial system were, in fact, pushed to the brink by the very same market forces.

**Sixth**, new approaches are needed to prevent the accumulation of large and unsustainable macroeconomic imbalances that lead to crises. Both surplus and deficit countries will have to undertake necessary adjustments in a coordinated manner. Global imbalances are largely the result of poor international coordination of macroeconomic policies. What is needed is an international coordination based on mutual adjustments rather than “beggar-thy-neighbor” policies currently pursued by several G20 economies.

Given the fundamental flaws of current global reserve system based on US dollar, China and UN agencies have proposed several alternative measures (including a new reserve currency to replace US dollar) to reform the global reserve system.

**Seventh**, the global crisis has vividly shown excessive procyclicality in the banking system. It has become evident that the Basel II Accord and international accounting rules encourage a pro-cyclical behavior. The financial regulation should rather promote the principle of counter-cyclicality which is good for individual banks as well as financial system as a whole.



The counter-cyclical policies curb excessive lending and risk taking during the boom periods and stimulate the economy through increased bank lending during the bust periods. Capital adequacy rules need to be revised to make sure that banks increase regulatory capital in good times so that they can absorb losses and continue lending in bad times. Building capital buffers during boom periods is vital to face unexpected instability.

**Eight**, a reformed financial system should be capable enough to provide adequate space and strength to individual countries to decide appropriate domestic economic policies as well as the level of their participation in the designing and implementation of a new architecture.

**Ninth**, Although the choice of regulatory model (single or multiple regulators, principle-based or rules-based regulations) will vary from country to country due to specific circumstances but the financial crisis has shown that no model can remain immune to financial instability.

It is evident that the risk management tools used by private banks and players were inadequate to assess risks in the financial markets. Many of the econometric models used by central banks also failed to anticipate the risks posed by banks and other players in the financial system.

**Tenth**, a boom and bust pattern of capital flows can undermine both macroeconomic and financial stability in the developing countries. Therefore, financial liberalization policies require serious reexamination.

There is a paradox between the gains of capital account liberalization in theory and in practice. The arguments supportive of capital account liberalization are highly overstated and backed by very little evidence. On the contrary, evidence shows that the benefits of free capital movements are much fewer in comparison with huge economic and social costs.

Conventional theory suggests that if there are no restrictions on capital mobility, capital should flow from the developed countries with abundant capital (e.g, US) to the poor and developing countries where capital is scarce (e.g., China). But the world is witnessing exactly the opposite. Since

2000, the developing world has become an exporter of capital to the developed world.

### **Thinking Beyond the Box**

The global financial crisis has seriously challenged the intellectual underpinnings on which the regulatory norms for markets, institutions and instruments were developed over the years. It has questioned the mainstream theoretical framework that the market-based allocation of capital is the best mechanism.

Until the crisis, constraints on markets players and instruments were viewed as inimical to financial innovation and efficiency of financial markets. Any intervention by regulatory agencies was strongly desisted on the grounds that markets should be left to regulate themselves and regulatory measures bring inefficiencies.

For almost three decades, the viewpoint that capital controls are inherently inefficient and distortionary held sway in global policymaking. After the collapse of Bretton Woods system, free flow of capital across borders became an important pillar of dominant economic thinking among Western nations, IFIs and mainstream academia.

In particular, the IMF became a vocal supporter of capital account liberalization. According to Stanley Fischer, former Deputy Managing Director of the IMF, “Free capital movements facilitate a more efficient global allocation of saving and help channel resources into their most productive uses, thus increasing economic growth and welfare.”<sup>2</sup>

The removal of capital controls became a key policy initiative under structural adjustment programs supported by the IFIs as well as bilateral trade and investment agreements. In July 2007, the former IMF Managing Director, Rodrigo de Rato, had asserted that capital controls were “rapidly becoming ineffective.”

Before the onset of the global crisis, many critical voices had warned

about the impending housing mortgage crisis in the US and its fallout on the financial sector but such views were largely ignored by the policymakers, IFIs, think-tanks and financial media. As late as April 2006, IMF's flagship publication, *Global Financial Stability Report*, stated that "the dispersion of credit risk by banks to a diverse and broad set of investors... has helped make the banking and financial system more resilient."<sup>3</sup>

Post-crisis, however, the dogmatic faith in market fundamentalism has been discredited. The pre-crisis model based on deregulation, open financial markets, free flow of capital across borders and light-touch regulatory framework has lost its appeal and legitimacy.

Of late, there is an unprecedented level of rethinking at several important institutions which pursued an orthodox policy making approach for many decades. This is best reflected in the case of IMF which published two important papers in early 2010 reassessing the macroeconomic and financial policy framework in the wake of financial crisis. Both papers challenge the conventional wisdom and IMF's prescriptions for low inflation rates and unbridled flow of capital across borders. The papers argue that higher inflation and controls on capital flows can help countries to protect themselves from financial shocks.

The first paper titled, "Rethinking Macroeconomic Policy" co-authored by its chief economist Olivier Blanchard, questions a number of orthodoxies related to inflation targeting. The second paper, "Capital Inflows: The Role of Controls," even argues that "capital controls are a legitimate part of the toolkit to manage capital inflows in certain circumstances."

It remains to be seen how far IMF will actually change its policy prescriptions on such key issues such as inflation targeting and capital controls. The decision-making processes at the IMF are nowhere de-linked from ideologically driven agenda and the power of special interests. It is unlikely that the IMF will quickly drop its reigning doctrines. Nevertheless, the ideas presented in these papers reflect a departure from IMF's long-

established orthodoxies and could open up space for more nuanced policy thinking.

Since no framework is perfect, policymakers should be more open to a diversity of policy approaches to maintain financial stability, rather than “one-size-fits-all” approach.

Many issues raised by the crisis could be better addressed if there is a space for heterogeneity in thinking and policymaking. The unorthodox policy measures such as capital controls should no longer be considered taboo in official policy circles.

### **The Need for International Cooperation**

Historically, regulation of financial system has been residing in the domestic domain. Due to rapid financial liberalization and globalization since the 1980s, it is beyond the capacity of a single country or institution to address the problems emerging from financial instability and systemic risk. International cooperation and coordination are essential in dealing with systemic crises posed by internationally active banks and financial institutions.

Although the enforcement of financial regulation remains within the jurisdiction of national authorities, well-coordinated regional and international arrangements with specific norms, procedures and institutional responsibilities could be worked out. For instance, recent international efforts to combat money laundering have led to its significant curtailment, if not elimination.

In the present times, there is no “quick fix” solution to resolve the myriad problems plaguing global finance. A combination of measures is required at both national and international levels to reform the present financial system. If there is a strong political will, a common international framework could be evolved which national regulatory agencies can implement according to their specific circumstances.

Post-crisis, the real challenge is to create a new international institutional structure which can address issues emanating from interconnectedness of financial markets and regulatory arbitrage.

The proposal for creating a global regulatory institution which can oversee the entire financial system in totality is not new but has picked up momentum in the wake of global crisis. The need for a global financial regulator is more feasible now than ever before. Such an institution can identify systemic risks posed by interconnectedness among different institutions in the global financial system and can work with national regulatory agencies to overcome such risks. It can also effectively check the rampant regulatory arbitrage.

Given the fact that many countries may resist conceding sovereignty to international institutions, it is likely that the idea of a global financial regulator may not see the light of day. The prospects of existing international institutions such as BIS and IMF playing the role of a global financial regulator lack credibility given the poor representation of developing countries in their decision-making structures and processes.

In comparison, regional cooperation mechanisms could be more appropriate, efficient and quick in controlling the contagion effects of a financial crisis. The regional institutions can quickly provide financial assistance to a country facing a crisis.

In the aftermath of the Southeast Asian financial crisis, the Chiang Mai Initiative (CMI) was taken up to establish a bilateral currency swap facility. Subsequently the size of swap facility was enlarged. In 2009, the network consisted of 16 bilateral arrangements among the ASEAN Plus Three countries worth \$90 billion.

The potential of CMI expanding into a comprehensive facility is enormous as its participating countries held more than \$4 trillion of forex reserves in 2009. Such regional financing arrangements not only could provide quick access to funds in times of a financial turmoil but could also serve as building blocks for a much larger and effective global financial safety net.

Similar financing and regulatory initiatives could be initiated in other regions. The de Larosiere Report (2009) has proposed a pan-European regulator called the European System of Financial Supervision, which could enforce common standards among European regulators.

While supporting the need for new international and regional institutional mechanisms, several important questions related to their accountability – who calls the shots, what is the modus operandi of decision making and who ultimately benefits from such decisions – cannot be overlooked.

Even in the absence of new institutional arrangements, there is a need for effective bilateral cooperation between home and host country agencies, particularly to supervise financial conglomerates which operate globally. As witnessed in the ECA region during the financial crisis, the cross-border information sharing was squarely missing among the supervisory bodies of home and host countries.

### **The Importance of Capital Controls**

There is a growing realization in international policy circles that due to limited effectiveness of other measures (such as higher forex reserves), capital controls could protect and insulate the domestic economy from volatile capital flows and other negative external developments. Capital controls could also provide host countries greater leeway to conduct an independent monetary policy.<sup>4</sup>

Contrary to popular belief, both the developed and the developing countries have extensively used a variety of capital controls to restrict and regulate the cross border movement of money, credit, capital goods, direct investment, portfolio investment and other financial instruments. Although the types of capital controls and their implementation varied from country to country, it would be difficult to find any country in the world that had not used these at some point or the other.

The significant decline in the use of capital controls (in both the

developed and the developing countries) corresponded with the ascent of neo-liberal ideology in the late 1970s.

There is a paradox between the use of capital controls in theory and in practice. Although mainstream theory suggests that controls are distortionary, ineffective and rent seeking, several successful economies have used them in the past.<sup>5</sup> China and India, two major Asian economies and “success stories” of economic globalization, still use capital controls today.

Capital controls were regarded as part of a solution to the global financial chaos in the 1920s and 1930s. Capital controls were widely used in the inter-war years and immediately after World War II. Given the fact that reconstructing economies and resuming foreign trade was the primary concern, most of the controls in the immediate post war period were associated with foreign trade. At that time, the basic link between capital controls and international trade was well acknowledged and the idea of cross border movement of capital through markets was almost inconceivable.

During the post-war period, even the mainstream wisdom favored the imposition of capital controls. John M Keynes strongly advocated the use of capital controls to protect economies from negative external economic and political disturbances. The experience of the Great Depression led Keynes to argue, “above all, let finance be primarily national.” He recommended that the use of capital controls be part of international economic agreements.

Capital controls can be quantity-based, price-based or regulatory.<sup>6</sup> Quantity-based controls involve explicit limits or prohibitions on capital account transactions. Such quantity-based measures on inflows may include a ban on investment in money market instruments, limits on short-term borrowing, restrictions on certain types of securities that can be owned, etc. On outflows, quantity-based controls can take the form of an explicit moratorium. For instance, Malaysia had imposed quantity-based controls in September 1998.

Price-based controls seek to alter the cost of capital transaction with a view to discouraging a certain class of flows and encouraging another set of flows. Price-based controls on inflows can take the form of a tax on stock market purchases, certain foreign exchange transactions, etc. Price-based controls on outflows can typically take the form of an exit tax.

Regulatory controls can be both price-based and quantity-based and such a policy package usually treats transactions with non-residents less favorably than with residents. An unremunerated reserve requirement is an example of regulatory controls on inflows.

The type of capital controls will differ from one country to another, depending on the nature and composition of financial flows and the institution through which capital flows take place.

In the present uncertain times, imposition of capital controls becomes imperative since the regulatory mechanisms to deal with capital flows are national whereas the financial markets operate on a global scale.<sup>7</sup>

While favoring the use of capital controls, one is not arguing that we should go back to the Bretton Woods system. Instead, we should learn lessons from the Bretton Woods system and try to emulate the positive features of the system while formulating policies and programs to regulate global capital flows.

It would also be incorrect to view capital controls as a panacea to all the ills plaguing the present-day global financial system. It needs to be underscored that capital controls must be an integral part of regulatory and supervisory measures to maintain financial and macroeconomic stability. Any wisdom that considers capital controls as short-term and isolated measures is unlikely to succeed in the long run.

Post-crisis, capital controls are back in fashion (see Box 6). Even the IMF is endorsing the use of capital controls, albeit temporarily and subject to exceptional circumstances. A paper prepared by the Strategy, Policy, and Review Department of the IMF stated “In certain cases countries may



## Box 6

**Capital Controls Gain Credence**

Post-crisis, there is a renewed interest in capital controls as a policy response to deter short-term volatile capital flows. In June 2010, South Korea and Indonesia announced several policy measures to regulate potentially destabilizing capital flows which could pose a threat to their economies and financial systems. In October 2010, Thailand imposed a 15 percent withholding tax on foreign purchases of Thai bonds in order to curb “hot money” inflows.

South Korea kicked off the process on 13 June when it announced a series of currency controls to protect its economy from external shocks. Indonesia quickly followed suite on 16 June when its central bank deployed measures to control short-term capital inflows.

The policy measures introduced by South Korea’s central bank have three major components, these being: restrictions on currency derivatives trades; enhanced existing restrictions on the use of bank loans in foreign currency; and, further tightening of the existing regulations on foreign currency liquidity ratio of domestic banks.

The new restrictions on currency derivatives trades, include non-deliverable currency forwards, cross-currency swaps and forwards. Also, new ceilings have been imposed on domestic banks and branches of foreign banks dealing with forex forwards and derivatives.

The over-arching aim of currency controls in South Korea is to limit the risks arising out of sharp reversals in capital flows. Despite its strong economic fundamentals, South Korea witnessed sudden and large capital outflows due to de-leveraging during the global crisis. It has been reported that almost \$65 billion left the country in the five months after the collapse of Lehman Brothers in September 2008.

Another policy objective of these policy measures is to curb Korea’s rapidly growing short-term foreign debt. At \$154 billion, its short-term external debt accounts for as much as 57 percent of its forex reserves. A sudden shift in global market sentiment can trigger large reversals in short-term capital flows thereby precipitating a financial crisis of one sort or another.

*continued on next page...*

Following three days later – 16 June 2010 – Bank Indonesia, the country's central bank, announced a one-month minimum holding period on Sertifikat Bank Indonesia (SBIs). During the one-month period, ownership of SBIs cannot be transferred. Issued by central bank, the one-month SBIs are the favorite debt instruments among foreign and local investors because of their high yield (an interest rate of 6.5% in early June 2010) and greater liquidity than other debt instruments. The central bank will also increase the maturity range of its debt instruments to encourage investors to park their money for longer periods.

These new curbs are in response to growing concerns over short-term capital inflows. Indonesia's relatively better economic performance has attracted large capital inflows in the form of portfolio investments since early 2009.

However, the Indonesian authorities remain concerned that its economy might be destabilized if foreign investors decide to pull their money out quickly. Analysts believe that these new measures may deter hot money inflows into the country and monetary policy may become more effective.

Despite recovering faster than developed countries, many emerging markets are finding it difficult to cope with large capital inflows. Apart from currency appreciation pressures, the fears of inflation and asset bubbles are very strong in many emerging markets.

The signs of asset price bubbles are more pronounced in Asia as the region's economic growth will continue to outperform the rest of the world. As a result, the authorities are adopting a cautious approach towards hot money flows and considering a variety of policy measures (from taxing specific sectors to capital controls) to regulate such flows. In May 2010, Hong Kong imposed new measures in an attempt to curb soaring real estate prices and prevent a property bubble. In October 2009, Brazil announced a 2 percent tax on foreign purchases of fixed-income securities and stocks. Taiwan also restricted overseas investors from buying time deposits. Due to this measure, Taiwan has witnessed a decline in speculative money from overseas. Russia is also contemplating similar measures as its economy is more vulnerable to swings in capital flows.

consider price-based capital controls and prudential measures to cope with capital inflows.”<sup>8</sup> This is a significant development given the IMF’s strong opposition to capital controls in the past.

### **Some Key Policy Recommendations**

Some key policy measures are briefly outlined below which can serve as a starting point for further debate and discussion.

#### **Curb Excessive Leverage**

The financial crisis has revealed the huge economic and social costs of excessive leverage in the financial system. The crisis has highlighted the systemic risks associated with increased use of procyclical leverage by investment banks, hedge funds and other financial institutions. The problem got further aggravated because many institutions responsible for excessive leverage in the financial system were outside the scope of supervisors.

As a first step, such institutions should be brought under the purview of supervisory authorities. As suggested by many observers, there are plenty of tools available which can limit overall leverage in banks and financial institutions, particularly during the boom periods.

#### **Regulate Highly Leveraged Institutions**

Much before the onset of global financial crisis, Germany had raised the issue of regulating hedge funds, private equity funds and other highly leveraged institutions (HLIs) at the G7 and other policy forums. Post-crisis, there is a renewed demand for both direct and indirect regulation of hedge funds and other HLIs.

The direct regulations will help in preventing market failures arising out of excessive risks by hedge funds. In this regard, several regulatory measures such as licensing requirements; public disclosures related to investments, leverage and derivative positions; capital requirements and

limits on leverage are under discussion. There is a growing consensus that the HLIs should be subject to higher capital requirements.

In addition, a significant restructuring of banks' disclosure and credit assessment practices in relation to the HLIs is necessary. As discussed in Chapter 4, hedge funds nowadays rely on investment banks for funding and other services as part of prime brokerage relationship. Due to heavy market concentration and interconnectedness among top prime brokers, contagion could quickly spread to the entire system if a big hedge fund goes bust. Therefore prime brokers and other financial institutions should be asked to disclose publicly their exposure to the HLIs, financial derivatives and other off-balance sheet items. Specific limits on leverage should be imposed on HLIs for seeking direct funding from prime brokers and financial institutions. Similar norms should also be applicable for private equity funds and other alternative investment funds.

Under a draft legislation called the Alternative Investment Fund Managers Directive, the EU has proposed new rules on hedge funds and private equity firms to address the issue of transparency and investor protection for those investing in such funds in Europe.

### **Rethink Financial Innovation**

The global crisis calls for a reassessment of the role and benefits of certain financial innovations taken place in the last two decades. From Bankers Trust to Enron, financial innovations have been the prime factors in perpetuating the collapse.

Securitization was supposed to disperse credit risk to those who were better able to bear it. But the financial crisis has vividly shown that securitization led to the concentration of risk with the financial intermediaries, rather than dispersal to outside investors.

Not all financial innovations are necessarily bad or good. In the retail banking segment, one of the most popular and useful financial innovations are the automated teller machines (ATMs). Several efforts are underway

in many poor and developing countries to promote financial inclusion through the use of biometrics cards and mobile banking. Without doubt, such financial innovations have economic and social benefits.

On the other hand, certain financial innovations have little or no social value because they are aimed at facilitating regulatory and tax arbitrage. The crisis has demonstrated that financial innovations in trading and wholesale banking segments in the form of derivatives products and

**Box 7****Basel III**

In September 2010, the Basel Committee on Banking Supervision released a set of rules on banks' capital requirements. The new rules, popularly known as Basel III, provide an update on the Basel Accords.

The new rules propose strict definitions of common equity held by banks, introduction of a leverage ratio and provisions for counter-cyclical capital buffers. Under the proposal, Tier 1 capital ratio has been raised from the current 2 percent to 4.5 percent of assets by 2015. A conservation buffer will add an additional 2.5 percent by 2019. The conservation buffer will help banks to absorb losses during the financial distress. The new rules will be implemented over the six years starting from January 2013.

The banking industry has criticized Basel III on the account that these rules could weaken the economic recovery and stifle economic growth. The Institute of International Finance, a lobbying organization of big banks, issued a report in June 2010 predicting that new rules could reduce real GDP growth by 3 percent in the G3 economies. No doubt, contemporary global finance presents difficult tradeoffs between financial stability and growth. Even if new rules stifle economic growth in the short term, there are far significant economic and social benefits of a stable banking system.

Will Basel III prevent another financial crisis? Critics have argued that the Basel III rules are timid and fail to address the root causes of financial crisis. Critics have also pointed out that the rules ignore the diverse needs of the banking sector in the poor and developing world.

securitization can bring huge economic and social costs. While the benefits of such financial innovations are usually cornered by a handful of traders, financiers and quants. Therefore, unproductive financial innovations with no tangible economic or social benefits deserve outright ban.

In those instances where the beneficial linkages between financial innovation and real economy are well established, it should be allowed with appropriate safeguards to check potential abuse.

### **Regulate Financial Derivatives**

Although financial derivatives are supposed to help reduce risk, in reality, they have become one of the biggest sources of volatility and instability in the global financial markets. Much of the growth in OTC credit derivatives happened due to lack of transparency and regulation. In the US, because of fragmentary regulatory structure, no regulator had the clear authority to regulate financial derivatives.

Post-crisis, several proposals have been made to reduce systemic risk associated with financial derivatives. The proposals range from more information disclosure and transparency to minimum capital requirements for all derivatives dealers and minimum collateral requirements for all derivatives transactions.<sup>9</sup>

Reforms are needed to bring OTC derivatives onto the exchanges and off-balance sheet items onto the balance sheets. Efforts have been made in the US and Europe to set up central counterparties (CCPs) for CDS contracts in order to increase transparency and improve counterparty risk management. These policy measures are indeed welcome but still fall short of curbing the misuse of financial derivatives for purely speculative purposes.

Under the proposed system, a central counterparty will act as an intermediary between two entities involved in a financial transaction. In case of a counterparty default, the impacts will be absorbed by the CCP. The trading entities will post collaterals with the CCP and would be subject to

daily margin calls. Despite such new features, the prices will still be negotiated over the counter.

Since large dealer banks dominate the derivatives trading, any default by a major dealer could trigger a collapse of a CCP, thereby inducing systemic risk. Moreover, OTC market will continue to thrive unless strict penalties in the form of higher capital and liquidity requirements are imposed for contracts not centrally cleared.

There are compelling reasons to outlaw “naked credit default swaps” where an investor holds insurance against the default of a particular bond without holding the underlying debt.

#### **Better Disclosure Standards**

The crisis has exposed the information gaps about the levels and concentrations of risk exposure of big financial institutions which were holding housing mortgages and related financial instruments. In the absence of information, large complex financial institutions could not monitor risk concentrations across products and borders.

There is a need for better disclosure norms which should cover both on- and off-balance-sheet items. All financial information (such as price, transaction value, counterparty, etc.) related to OTC derivatives should be made available so as to reduce systemic risk.

A greater market transparency can help regulators to assess and detect risks within the financial system.

#### **Tax Financial Transactions**

Professor James Tobin in his Janeway Lectures at Princeton first proposed a tax on global foreign exchange transactions in 1972, it came to be popularly known as Tobin tax.

In the subsequent years, James Tobin had modified and further elaborated his earlier proposal. Realizing the need for “throw(ing) some sand in the

wheels” of global financial markets, he advocated the tax as a mechanism for discouraging speculation in short-term foreign exchange dealings.

James Tobin proposed a 0.25 percent tax on currency transactions in order to control volatility in the global currency markets and to preserve some autonomy in national monetary policies. Essentially a Keynesian proposition, the underlying logic of a Tobin tax is to slow down speculative, short-term capital flows, as they will be taxed each time they cross the border. The support for Tobin tax gained urgency and popularity in the wake of Mexican and Southeast Asian financial crises. In response, a number of civil society groups also launched campaigns urging for a Tobin tax.

The taxes on financial transactions have a long history. Taxes on various kinds of financial transactions have been imposed in several countries including the US, Germany and the UK. Since the mid-1970s, Argentina, Brazil and Venezuela have imposed taxes on bank transactions. Taxes on securities trading are still prevalent in India, Brazil, China and Indonesia. The objectives for a FTT are essentially two-fold: to raise revenue; and reduce speculation and volatility in the financial markets.

The global financial crisis has renewed interest in the idea of taxing global financial transactions. There is a considerable support to FTTs among several G20 member-countries. Germany and France have endorsed a global tax on all cross-border financial transactions.

Initially the IMF was reluctant to back such a tax but due to growing popularity and political support, the IMF has proposed two new taxes (financial stability contribution and financial activity tax) on the banks to cope with future crises. The financial stability contribution is a flat tax applied on all banks to generate a self insurance fund equivalent to 4.5 percent of each country’s GDP. The financial activity tax will be charged on the profits and remunerations of banks.

Some developed countries have proposed or established levies to deal with cost of future crises. In January 2010, the US has proposed a Financial



Crisis Responsibility Fee on banks and financial institutions to recoup the taxpayer's money involved in bank bailouts. The UK and France have also imposed a levy on bonus payments. Some economists have also proposed a Pigovian tax (named after economist Arthur Pigou) to address negative externalities generated by global finance.

**Box 8****Securities Transaction Tax in India**

In 2004, India introduced a Securities Transaction Tax (STT) in equity markets. Currently, STT is charged at the rate of 0.125 percent on a delivery-based buy and sell transactions and 0.025 percent on non delivery-based sale transactions. The rate is 0.017 percent on F&O sale transactions. Imposed on both foreign and domestic investors, the STT is collected by the stock exchanges from the brokers and passed on to the exchequer, thereby enabling the authorities to raise revenue in a neat and efficient manner.

Termed as "Terminator Tax," the STT was strongly opposed by a lobby of speculators, day traders, arbitrageurs, and "noise traders." Many of them had predicted that the introduction of STT would bring Indian financial markets to a standstill. There were strong apprehensions that STT would dry up liquidity.

Since its implementation, all apprehensions related to STT have proved erroneous. The fact that there is too much liquidity in the Indian markets is also admitted by the critics of STT. The implementation of STT has also reduced some loopholes in the existing tax regime. For instance, foreign investors who used to take undue advantage of the bilateral direct tax avoidance treaties (such as India-Mauritius tax treaty) are now taxed under the STT regime.

Since its implementation, Indian authorities have collected sizeable revenue. During the fiscal year 2009-10, the government's revenue from STT was Rs. 59940 million (\$1.3 billion), a substantial amount in the present times when tax revenues are under severe pressure. However, the trading trends reveal that the STT did not help much in reducing the levels of speculation and volatility in the Indian equity markets, as anticipated by proponents.

### **A Reformed IMF**

Although the IMF had lost its *raison d'être* with the collapse of Bretton Woods system in the early 1970s, not only has it managed to reinvent itself but, more importantly, it has also assumed the role of an international lender of the last resort. Over the years, the IMF has moved away from its original mandate of providing short-term stabilization loans to countries facing balance of payments problems. Particularly, since the 1980s, the IMF has moved into medium-term adjustment programs advocating structural reforms such as privatization and financial liberalization.

At present, the proposal to reform the IMF has a far higher degree of international support than any other proposal. Several steps could be undertaken to reform the IMF. For instance, the IMF should be made to stick to its original mandate and competence. As countries often need liquidity to tide over external imbalances, the IMF can continue to provide short-term stabilization lending. It must stop prescribing medium- and long-term structural adjustment reforms. Further, the IMF should not pursue amendments in its Article of Agreement to include capital account liberalization.

The IMF lacks legitimacy because of its orthodox policy prescriptions and poor governance structures. For IMF to play a central role in international financial affairs, it is important that its “money-for-influence” structures of representation and governance are drastically reformed. The poor and developing countries should have greater voice and representation in IMF’s decision-making structures and processes. In October 2009, the G20 asked the IMF to undertake a review of its mandate. The G20 leaders also supported a shift of at least 5 percent in quota share towards dynamic emerging markets and developing countries which are currently underrepresented at the IMF. But much more fundamental reforms both in its policy outlook and governance are need for IMF to claim legitimacy and credibility in the international community.

Structural reforms are also needed in the management and governance

of the World Bank. In April 2010, the World Bank endorsed a 3.13 percentage point increase in the voting power of developing and transition countries at IBRD. The increase in voting power has mainly benefited the big and most dynamic emerging markets such as China, Brazil and India.

### **Strictly Regulate Rating Agencies**

The crisis has questioned the ethics and conduct of credit rating agencies. However, this is not the first time that the conduct of credit ratings has come under criticism. During the Southeast Asian financial crisis of 1997, international rating agencies overreacted by downgrading the affected economies to junk status.

These agencies should be brought under a regulatory oversight regime given the key role played by them in securitization and other financial matters. Their transparency, rating methodologies and governance standards need to be improved. Strict rules should be devised to prevent the conflicts of interest in their functioning.

Given the fact that many rating agencies have global outreach, there should be closer cooperation among national authorities overseeing these agencies.

The EU has proposed new rules requiring ratings agencies to register and undergo direct supervision if they want to issue ratings in its member-countries. These should be followed up by other measures including breaking up the big three oligopoly in the ratings industry. Efforts should be made to reduce reliance on opinions issued by rating agencies.

### **Curb Dubious Activities of Offshore Financial Centers**

Post 9/11, the international community has started paying attention to the world of offshore financial centers (OFCs) as they provide legitimate space for unregulated financial players such as trust companies, shell companies, hedge funds and brokerage houses.

Because of lax regulations, OFCs have been used not only to launder the proceeds of drug trafficking and other crimes but also aid and abet certain kinds of financial crime. Some recent international initiatives have led to sharing of information and internal regulation by offshore authorities.

### **Regulate Bankers' Compensation**

Compensation practices of big banks and large financial institutions have come under public criticism in the developed world. No one can deny that the performance-based remuneration induced risky behavior in the bankers and traders.

Since a large portion of bankers' compensation is usually linked with short-term profits which encourage them to take greater risk taking, it is important that that compensation should be consistent with the business performance of the bank rather than short-term trading profits. Besides, the inherent market incentive structures that promoted unhealthy compensation practices in the financial industry need to be curbed.

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# 8

## **Global Financial Reforms and Developing Countries**

At present, the debate on global financial reforms is focused on strengthening the financial systems of the developed economies – the epicenter of global financial crisis. Even though the financial systems of poor and developing countries are considered to be undeveloped and unsophisticated, these countries can bring new perspectives into the ongoing debates. It is likely that the perspectives of developing countries would be sharply different from the developed one given the diverse roles and objectives of financial system in their economies.

For developing countries, systemic risk issues are of greater importance because, more often than not, the main sources of systemic risk and vulnerability are beyond their jurisdictions. Take the case of capital flows. For decades, developing countries have been finding it difficult to cope with volatile capital flows. The management of volatile capital flows becomes more difficult for those developing countries which follow a highly open economy. Several developing economies have experienced sudden reversals in capital flows due to changes in the monetary policies of developed economies. The domestic authorities in the developing countries have no control over such developments.

The costs of financial instability and crisis are more pronounced in the poor and developing world because of weak regulatory and supervisory institutions. The social costs of financial crises are also much higher in the poor and developing countries since they lack social security nets and fiscal space for counter-cyclical measures is rather limited. Therefore, it is very important for these countries to maintain financial stability.

### **Managing Volatile Capital Flows**

A boom and bust cycle of capital flows engenders both macroeconomic and financial instability. Periods of large capital inflows are usually

followed by a sudden outflow of capital. A surge of capital inflows can contribute to higher inflation and asset price bubbles. The sudden withdrawal of capital can seriously affect the exchange and interest rates, and thereby threaten macroeconomic management and economic stability not only in one country but several others, depending on the degree of economic integration.

There was a sudden reversal of capital flows during the crisis due to global deleveraging. Large-scale reversals of capital flows were witnessed even in those developing countries with strong macroeconomic fundamentals.

For developing countries, the problems associated with capital flows are two-fold: First, capital flows don't enter a country at the right time. But capital can leave a country quickly at a time when it is badly needed.

Second, the quality of capital flows poses new risks and policy dilemmas. The developing countries have witnessed a sharp rise in "hot money" and portfolio investments in recent years. Since the bulk of portfolio investments are short-term and speculative in nature, their contribution to economic growth in host countries is minimal. Besides, much of portfolio investments are prone to reversals. Several episodes of financial crisis in Mexico, Southeast Asia and Turkey in the 1990s point to the preeminent role of unregulated short-term portfolio flows in precipitating a financial crisis.

### **The Impossible Trinity**

For developing countries, it becomes very difficult to maximize the benefits and minimize the costs of capital flows. How to manage the impossible trinity – free capital movement, a fixed exchange rate and an independent monetary policy? As noted by D. Subbarao, Governor of RBI, "If central banks do not intervene in the foreign exchange market, they incur the cost of currency appreciation unrelated to fundamentals. If they intervene in the forex market to prevent appreciation, they will have additional

systemic liquidity and potential inflationary pressures to contend with. If they sterilize the resultant liquidity, they will run the risk of pushing up interest rates which will hurt the growth prospects.”<sup>1</sup>

If the developing countries hold large foreign exchange reserves to buffer against sudden capital outflows, it poses new risks. Large forex reserves put pressure on a country's exchange rate so that the currency appreciates, negatively affecting the competitiveness of exports. Excessive reserves could induce asset price bubbles and higher inflation by way of an excessive money supply. There are fiscal costs as well, as the authorities may lose control of monetary policy.

### **Is FDI a Panacea for Growth?**

There is a common assumption that foreign direct investment (FDI) offers immense benefits to developing countries in terms of transfer of technology, creation of jobs, quality products and services, along with managerial efficiency. These perceived benefits may hold true for some investments, but it would be a serious mistake to make broad generalizations because hosting investment flows is not without its potential costs.

The foreign investment has important implications for governments and domestic firms as well as for workers, consumers, and communities in the host countries. Unfortunately, neoliberal approaches do not give adequate attention to these economic, social, and environmental costs and thus fail to establish the links between foreign investment and poverty reduction and development.

These concerns become even more relevant in the present context when attracting foreign direct investment flows is seen by policy makers as an important instrument to achieve higher economic growth and to reduce poverty.

There is hardly any reliable cross-country empirical evidence to support the claim that FDI per se accelerates economic growth. In the present circumstances, it is quite difficult to establish direct linkages between FDI



and economic growth if other factors such as competition policy, labor skills, policy interventions and comprehensive regulatory framework are not taken into account. Further, in the absence of performance requirements and other regulations, many of the stated benefits of FDI would not occur.

In the last two decades, the attributes of FDI flows, known for their stability and spillover benefits, have also changed profoundly. FDI is no longer as stable as it used to be in the past. The stability of FDI has been questioned in the light of evidence which suggests that as a financial crisis becomes imminent, large transnational corporations indulge in hedging activities to cover their exchange rate risk which, in turn, generates additional pressure on the local currencies.

Since bulk of FDI flows are associated with cross-border mergers and acquisitions, their positive impact on the domestic economy through technological transfers and other spillover effects has been significantly diluted.

In most developing countries such as India, China and Malaysia, FDI is often encouraged because it is considered to be a non-debt creating capital. It is true that FDI does not involve the direct repayment of debt and interest, but at the same time, it does involve substantial foreign exchange costs. Capital can move out of a country through remittance of profits, dividends, royalty payments, and technical fees. In the case of Brazil, foreign exchange outflows in the form of profits, royalty payments, and technical fees rose steeply from \$37 million in 1993 to \$7 billion in 1998.

Due to rapid financial liberalization, the trend of significant foreign exchange outflows with a resulting negative impact on a country's balance of payments has gained additional momentum. This trend is most evident in several African economies such as Botswana, Democratic Republic of Congo, Gabon, Mali, and Nigeria where profit remittances alone were higher than FDI inflows during 1995-2003.

If FDI is not oriented towards exports, it can have serious implications

for developing countries which are usually short of foreign exchange reserves. In recent years, the share of services in total FDI inflows to the developing world has increased. Since many services (such as telecom, energy, construction and retailing) are usually not tradable, investments in such services would involve substantial foreign exchange outflows over time in the form of imports of inputs, technology, royalty payments, and repatriation of profits.

### **Curb Illicit Capital Flows**

Capital can move out of the country via illegal means such as abusive transfer pricing and creative accounting practices. It is an established fact that transnational corporations often indulge in manipulative transfer pricing to avoid tax liabilities. Only recently, tax authorities in the developing world have taken cognizance of widespread abuse of transfer pricing methods by TNCs.

The issue of illicit financial flows needs serious attention as corrupt rulers, drug cartels and mafia have used Western banks and tax havens to move millions of dollars out of their countries. A recent study by Global Financial Integrity estimated that “illicit financial flows out of developing countries are some \$850 billion to \$1 trillion a year.”<sup>2</sup>

### **Access to Trade Finance**

Trade finance is another area where the impact of global crisis was disproportionately felt by small-and medium-enterprises (SMEs) in the poor and developing world. Evidence suggests that SMEs in Philippines, India and Mexico were crowded out by large firms trying to access to trade finance. The deterioration in trade finance markets led to a sharp rise in spreads on credit and insurance costs, which in turn made trade finance transactions highly expensive.

In the earlier episodes of financial crises in emerging markets such as the Southeast Asian financial crisis in 1997 and the Argentine crisis in 2001, trade finance (particularly short-term segment) dried up.

One of main causes behind recent contraction in trade finance is the pro-cyclical effect of Basel II rules devised by the Basel Committee on Banking Supervision of the Bank for International Settlements. Basel II rules impose a significant increase in the risk weight for trade finance in comparison with Basel I rules. Certain provisions need to be amended to make sure that trade financing is not constrained by Basel rules.

### **Why Financial Inclusion?**

Since financial inclusion helps people to come out of poverty, the new financial architecture should encourage financial inclusion. A stable financial system should contribute in economic growth and sustainable development.

The linkages between finance and development need to be strengthened. Rather than resembling a casino in which assets are traded primarily for speculative profits, the financial system should serve the real economy and sections of society who are financially excluded.

It is estimated that nearly three billion people worldwide currently lack access to basic banking services. Although financial exclusion is more acute in poor countries, a substantial section of poor households in the developed countries remains unbanked. A survey conducted by FDIC in 2009 found that 9 million households in the US do not have a bank account. In addition, nearly 21 million households are underbanked in the US. In total, nearly one in four US households is either underbanked or unbanked. In the UK too, almost a million adults do not have a bank account.

For developing economies, financial inclusion is imperative for inclusive economic growth. There are vast sections of population without access to banking and other financial services. These countries are seeking financial innovation to deliver financial services to remote and poor areas. Therefore, financial innovation should be driven by the objectives of social and developmental banking.

The performance of big foreign banks in promoting financial inclusion

in many developing countries including India and Indonesia is poor. The Indian experience clearly show that unlike state-owned banks, foreign banks are reluctant to provide affordable basic banking services (such as bank accounts, credit, remittance and payment services) to disadvantaged and poor people who are financially excluded. The urban-centric foreign banks largely serve the niche market segments consisting of HNWI and large corporations in India. The role of foreign banks in social and development banking is negligible. The inclusive banking is carried out by state-owned banks and rural banks.

### **Restructuring Domestic Financial System**

In the poor and developing world, there is an urgent need for a fundamental reorientation of the domestic financial system and the real economy with selective linkages with the globalization processes. A selective de-linking from fly-by-night financiers and “hot money” flows is not only desirable but also feasible.

The financial system should be modified to serve the needs of the real economy and particularly those sections of society who have been marginalized by the market forces. Though the role of foreign investment cannot be negated, growth must emanate primarily from domestic savings and investment. Rather than focusing on export led growth, domestic markets should act as the prime engines of growth. Besides, principle of equity must be on top of the agenda of governments.

Domestic resource mobilization is essential for building sustainable development. A progressive broad-based direct taxation system has the ability to enhance domestic financial resources. This will help poor and developing countries to finance an increasing share of their development needs from domestic sources.

The developing countries should also rethink the costs and benefits of bilateral tax treaties in the form of Double Tax Avoidance Agreement (DTAA). At present, there are more than 3000 tax treaties in force

throughout the world. India alone has entered into over 75 bilateral tax treaties. The tax authorities should undertake provisions to prevent the frequent abuse of tax treaties through treaty shopping and round tripping.

The poor and developing countries should effectively use credit controls to encourage disbursement of credit to agriculture, small businesses and weaker sections of society.

Even though securitization and derivatives markets are in the nascent stage in most developing countries, the national regulatory authorities should strengthen the regulatory and supervisory frameworks before such financial products are allowed.

The developing countries should strongly resist temptations to set up offshore financial centers within their jurisdictions. In addition, countries should closely supervise their external debt position, especially the short-term debt.

### **Revisiting Capital Account Liberalization**

The imminent role of financial liberalization in triggering financial crises is well documented. The Southeast Asian crisis has emphatically demonstrated to the world that capital account liberalization is a vexatious issue with numerous reverberating effects.

It is imperative for developing countries to manage their capital account. Thanks to capital controls, India and China were not badly engulfed by the Southeast Asian currency crisis in 1997. If India and China had adopted capital account liberalization; it would have been difficult to protect their economy from the Asian turmoil.

For developing countries, the costs of an open capital account are enormous because volatile capital flows can cause sharp swings in real exchange rates and financial markets thereby engendering instability in the financial system and the real economy.

Contrary to the popular perception, capital account liberalization

does not lead to higher economic growth. China and India are prime example of achieving higher economic growth without liberalizing capital account. The potential costs of free capital movement are much higher in comparison with the much-touted benefits.

Therefore, current approaches advocating liberalization of capital account in the developing countries should be revisited.

### **Free Trade Agreements, Investor Rights and Capital Controls**

The developing countries should reconsider the benefits and ill-effects of unbridled liberalization of financial sector under the framework of bilateral investment and trade agreements.

The existing frameworks of investment treaties are highly biased in favor of protecting foreign investors' rights while constricting the policy space of countries to intervene in public interest. Take the case of North American Free Trade Agreement (NAFTA). Private corporations from NAFTA member-countries have exploited the provisions of the agreement to challenge those regulatory measures that infringe on their

#### **Box 9**

#### **Key Policy Proposals**

A number of policy measures have been put forward by economists, think tanks and UN agencies to reduce the vulnerability of developing countries to external shocks.

Some of these policy measures include special and differential treatment in financial regulation, greater policy space, developing regional markets and financing mechanisms, restrictions on volatile financial flows, channelizing long-term investment flows for development, increasing access to trade finance, greater participation and voice in the global economic governance and closer coordination of finance, trade and aid processes. In addition, governance reforms of bilateral and regional trade agreements are important to protect the interests of small and vulnerable poor economies.

investment rights. The growing conflicts between private corporations and regulators are the outcome of the investment provisions under Chapter 11 of the NAFTA which entails non-discriminatory treatment to foreign investors.

It is in the interest of developing countries to make sure that investment treaties should not constrict the policy space to maneuver investment policies in accordance with their developmental priorities.

Certain trade and investment agreements can hinder the ability of countries to use capital controls in order to tame currency and market volatility. Since such agreements have “lock in” obligations, surrendering the ability to deploy capital controls in return for more favorable market access should set the alarm bells ringing in the developing world. If bilateral trade agreements banning capital controls become *de rigueur* it means a country using them to defend its economy will end up compensating foreign investors for the inconvenience. A newly published IMF document has also acknowledged that capital controls may, in some cases, be “inconsistent with GATS obligations.”<sup>3</sup>

There is much to learn from Iceland which experienced the worst financial crisis in its modern history. Iceland had to impose capital controls when its highly indebted banking sector collapsed in October 2008. The controls were necessary to maintain exchange rate stability and restructure the domestic financial system.

Technically speaking, capital controls imposed by Iceland are a violation of various international agreements signed by the country. In particular, controls are inconsistent with the country’s specific commitments under the GATS.<sup>4</sup>

In the light of this experience, countries should review their commitments made under the GATS and bilateral trade agreements. Certain bilateral agreements (such as US-Chile and US-Singapore) which curb the use of capital controls need to be revised.

### **Rethinking Banking Services Liberalization**

In the wake of global financial crisis, there should be serious rethinking on the benefits of banking sector liberalization and deregulation. The proponents of banking services liberalization tend to overlook the potential costs associated with the entry of foreign banks in host countries. If the entry of foreign banks is allowed through acquisition of domestic banks, it may lead to concentration of banking markets and loss of competition. In many Latin American countries such as Brazil and Chile, there was a considerable decline in competition in the aftermath of liberal entry of foreign banks.

The foreign banks can be a source of cross-border contagion from adverse shocks originated elsewhere. A large presence of foreign banks originated in crisis-ridden countries could lead to rapid transmission of financial shocks in the host countries. Several internationally active banks drastically reduced cross-border lending during the current financial crisis.

The parent bank may also reduce exposure in a host country or move out completely due to losses suffered in home or other countries. A number of European banks have exited from Asian countries as the global financial crisis forced them to focus on their home markets. The Royal Bank of Scotland has decided to exit from or shrink its operations in 36 countries (including India and China) due to problems at its parent bank.

In addition, it is highly debatable whether foreign banks presence has a stabilizing role in the case of a systemic crisis. In Argentina, for instance, several foreign banks chose to leave the country when a financial crisis erupted in 2001. In the aftermath of Asian financial crisis, foreign banks substantially reduced lending in South Korea and Indonesia.

Furthermore, the entry of foreign banks poses new challenges to regulation and supervision. The regulatory and supervisory authorities are restricted to their national borders while foreign banks can easily cross national borders and operate internationally. The overall responsibility for the parent bank remains with the regulatory authorities in the home



country. But there is little coordination and sharing of information among the regulatory authorities of home and host countries.

The crisis has proved that increased financial integration can transmit financial shocks across countries. Financial innovation in certain products and markets can also augment financial shocks. The presence of large financial conglomerates in domestic financial system requires close monitoring by supervisory authorities in developing countries.

Keeping these important developments in view, the policy makers in the developing countries should rethink about the benefits and costs of opening up of banking and financial services.

### **Greater Voice and Representation**

The poor and developing countries are not adequately represented in international financial policy forums and institutions (such as IMF and World Bank). This is also reflected in G20 which is considered to be a major international institutional innovation of recent times. G20 is marginally better than G8. At G20, only a handful of big developing economies are part of discussions on global monetary and financial issues. South Africa is the only African country representing over one billion people at the G20. There are numerous small and vulnerable countries whose concerns are not likely to be addressed by the G20. Critics have pointed out that the agenda-setting of G20 is predominantly done by the developed countries. On important financial issues such as financial transaction taxes and capital controls, G20 has yet to take a collective stand.

The BIS is another international financial institution with 13 of its 19 board members representing Europe. The Financial Stability Board and the Basel Committee on Banking Supervision also lack adequate representation of the poor and the developing world.

Unlike developed countries, there is hardly any meaningful coordination among the developing countries on global financial and

monetary issues. The existing forums consisting of developing countries lack multilateral credibility because of poor representation of smaller economies.

The G24 (Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development) is an old forum which represents the position of developing countries on monetary and development finance issues. But the G24 lacks the strong political backing by some of its large member-countries such as India and Brazil which diminishes its potential role in reforming global financial system.

The new forums among developing countries such as IBSA (a trilateral, developmental initiative between India, Brazil and South Africa to promote South-South cooperation) and BRIC Summit have pushed the agenda of reforming the global financial system but are very limited in their memberships.

What is missing is the voice and representation of a large number of poor and developing countries (directly and indirectly) in the ongoing debates at various international forums.

### Notes

1. D. Subbarao, "India and the Global Financial Crisis: Transcending from Recovery to Growth," comments at the Peterson Institute for International Economics, Washington DC, April 26, 2010.
2. Dev Kar and Devon Cartwright Smith, *Illicit Financial Flows from Developing Countries 2002-2006*, Global Financial Integrity, Washington, December 2008.
3. IMF, *Reference Note on Trade in Financial Services*, September 3, 2010, p. 7 (<http://www.imf.org/external/np/pp/eng/2010/090310.pdf>).
4. For a detailed analysis, see Annamaria Viterbo, "The Return of Capital Controls as Emergency Tools to Counter Financial Crises – Iceland's Crisis and the Constraints Imposed by the EEA Agreement," Society of International Economic Law (SIEL), Second Biennial Global Conference, University of Barcelona, July 8-10, 2010 (Available at SSRN: <http://ssrn.com/abstract=1633989>).

# 9

## **Global Financial Reforms and Civil Society: A Bottom-Up Approach**

The crisis has proved beyond doubt that financial stability is a global public good and unless the international financial system is reformed, no country can remain immune from external shocks. In many important ways, it provides an opportunity to restructure and reform the present global financial system.

The focus of this chapter is on citizens' organizations, social movements, women's and labor groups seeking to influence global financial flows and institutions.

Since the 1980s, these groups have emerged as a significant force in the national and global arenas. The important role played by such groups in bringing the debt issues to international policy forums is well recognized. Since the 1980s, several campaigns have been launched to reform the international financial institutions (such as IMF and World Bank) and regional developmental banks.

After the Southeast Asian financial crisis, some campaigns on specific issues related to global finance were also initiated. The international campaign on Tobin tax (e.g., ATTAC) is a case in point. Despite such recent initiatives, the global civil society's engagement with the governance of private capital flows is rather weak and diffused.

### **Popular Participation and Democratization**

Since global financial issues affect the lives and livelihoods of vast majority of people, these cannot be left in the hands of experts, rich bankers, financiers, IFIs and central bankers.

The need for an informed debate on global financial reforms is more than ever. The debates on global financial issues could be broadened by the active participation of people and their representative bodies to ensure

that the global finance serves the needs of the real economy and people at large.

The concept of people's participation should not be restricted to only sharing of information but, more importantly, it implies active involvement in the decision-making processes. As pointed out by Tony Porter, "Civil society actors need to engage in more meaningful dialogue with the approaches, issues, and actors that currently dominate the policy process in global financial governance. This does not mean blunting their criticisms, but rather sharpening them by homing in on the practical mechanisms and subtle but dangerous and exploitative abuses that are at the leading edge of the developing infrastructure for financial policy and market transactions, and that can determine the future direction of the development."<sup>1</sup>

Given the present geopolitical conjuncture, one cannot expect major structural changes in the global financial system to take place without popular mobilization and empowerment of people in both developed and developing countries. Perhaps more in the developed countries as the current financial crisis originated there and these countries are the main source of private capital flows to the developing world.

In this context, citizens' organizations and social movements can play a catalyst role in articulating popular demands and building pressure from below. With the help of mass media and Internet, the potential to respond to the emerging global financial issues is enormous at all levels – local, national and international.

To begin with, civil society actors need to acquaint themselves with the ongoing debates on reforming global finance. By and large, there has been lack of information and comprehension on such issues. Without doubt, financial matters are very complex and a thorough understanding of them requires a considerable amount of technical expertise and experience which many civil society groups do not possess. But there are no shortcuts. The civil society groups should comprehend the technical complexities in order

to develop a critical understanding of global finance and its flaws. This will require understanding the workings of private players, financial markets, domestic regulatory and supervisory agencies, central bank, finance ministry, the deposit insurance institution and other institutions. Tony Porter sums up the importance of technical complexity well:

It is important for those concerned about the negative effects of global finance to take technical issues more fully into account if practical solutions to current and future problems are to be advocated in addition to highlighting past injustices... It is best not to ignore or dismiss technical details, or to insist that this detail be left to experts, but rather to try to understand the political and ethical implications of this technical complexity.<sup>2</sup>

### **Campaigning on Private Capital Flows**

While civil society groups should continue their activities on reforming the IFIs (such as IMF and World Bank), it is important to emphasize that the previous successful strategies of campaigning on IFIs are unlikely to pay dividends in the case of private capital flows.

While the World Bank and other multilateral institutions have a mandate for poverty alleviation and sustainable development (although their intent, commitment and approach to such issues are open to question), investment banks, hedge funds, equity funds and other private players are only interested in reaping profits, have no people oriented developmental agenda, and are only accountable to their shareholders. Moreover, there is little or no transparency worth comment in their operations.

It might be relatively easier to target campaigns and monitor the workings of the IMF, World Bank and the ADB since they are centralized institutions. However, a similar strategy can not be deployed in case of global finance capital as it is liquid, decentralized and footloose in nature, moving from one country to another in no time. This makes monitoring such financial flows an extremely difficult task.

Earlier strategies of campaigning (e.g., labor or environmental action) on FDI flows may not be appropriate in the case of footloose finance capital.

### **Devising A New Strategy**

The global crisis provides a unique opportunity for social movements to devise a new development strategy so as to avoid financial, social and environmental crises in the future. In this regard, some groups have taken the lead to launch a global green “New Deal.”

In the present political economy context, an action program calling for total de-linking of domestic economy from global financial flows may not succeed. Action programs based on curbing unbridled international financial liberalization and selective de-linking from speculative and volatile financial flows may have better chances of success. The terms and conditions of linkages with global financial flows should be decided by the nation states rather than by global financial markets and IFIs.

Progressive tax reforms and restrictions on capital flows should be high on the agenda of civil society organizations. If groups have popular support at the grassroots, there is every possibility of devising an investment strategy that allows only such financial inflows that are beneficial to the domestic economy.

The campaign strategies will vary from country to country depending on the specific national context, yet a number of common programs could be planned in both the recipient and the source countries.

The civil society groups could demand major structural reforms since the benefits and costs of global finance are distributed very unevenly both at national and international levels. They can exert pressure from below on regulatory bodies for the implementation of stringent rules and standards.

Certain types of financial actors (e.g., hedge funds and private equity funds) are highly unregulated in their source countries. Efforts should be

made to seek the support of middle class investors who invest their savings in the mutual funds, pension funds, bonds and other financial instruments. A substantial amount of capital – which the international fund managers move across the border with impunity – belongs to this community.

### **From Poverty to Democratic Power**

Financial stability calls for a greater role of the state and coordination among regulatory bodies. Even though the power of the nation state has been weakened in the era of financial globalization, governments are still active participants in the creation of rules, laws and institutions governing global finance.

Financial globalization is not merely technologically driven. Power and politics, within the nation state, define the context of international capital mobility.<sup>3</sup>

Despite global integration, there is every possibility that nation states can restore relative autonomy in the management of their economies. Since the existence of nation state cannot be wished away, activists and groups should make renewed efforts to make it accountable and democratic. The agenda of global financial reforms should be a part of wider project of democratic renewal.

At the national level, civil society groups should advocate greater regulation and supervision of systemically important financial institutions, particularly large conglomerates. Capital controls is one issue which has not received much attention by civil society groups. As discussed in Chapter 7, capital controls can stem the inflow and outflow of speculative money. The groups can initiate activities on liberalization of financial services under the WTO and bilateral trade agreements.

In the developed world, the idea of financial transaction taxes has generated avid interest among many economists, NGOs, trade unions and political groups in recent years. Post-crisis, this idea has also received support in many official circles. There is a need for launching popular

education and research activities on FTTs in the developing countries. Civil society groups could also undertake activities on regional financial mechanisms such as Chiang Mai Initiative.

As the financial crises are increasingly taking global dimensions, social movements likewise have to take a global stance. Although the arena of popular mobilization may remain national, cross border alliances and linkages with international groups need to be developed and strengthened. The campaigns on reforming global finance cannot be launched in exclusivity, rather they should be an integral part of cross sectional movements for democratic control and accountability of global economic governance.

### **Civil Society and Global Policy Forums**

Apart from IFIs, the NGOs and peoples' movements will have to grapple with two major international institutions: Bank for International Settlements (BIS) and The International Organization of Securities Commissions (IOSCO).

Established in 1930 and based in Basel, BIS continues to be a Euro-centric institution, with 13 of its 19 board members from Europe. The BIS is an inter-state organization of central banks with a mandate to pursue international monetary and financial stability. The Basel Committee on Banking Supervision (BCBS) is one of the most important international bodies involved with the regulation of international banks. The Committee's secretariat is located at the BIS.

Based in Spain, IOSCO is the leading international policy forum for securities regulators. The organization's membership regulates more than 95 percent of the world's securities markets in over 100 countries. Both these institutions have not come under close public scrutiny.

Simultaneously, civil society groups should closely follow the developments in important global policy forums such as G20. They should demand that global policy forums should have a developmental agenda



and be guided by open democratic processes and wider participation of countries.

The real challenge before civil society organizations resides in enforcing the adoption of a genuinely participatory agenda in the operations of financial markets and regulatory bodies. Citizens and their representative bodies will have to develop innovative approaches so as to bring discipline and democratic accountability in the operations of both markets and public institutions.

#### Notes

1. Tony Porter, *Globalization and Finance*, Polity Press, 2005, p. 197.
2. *Ibid.*, p. 188.
3. Gerald Epstein, "International Capital Mobility and the Scope for National Economic Management," in Robert Boyer and Daniel Drache, *State against Markets: The Limits of Globalization*, Routledge, 1996, p. 221.

## **Glossary**

<b>Arbitrage</b>	Earning profit from differences in price when the same security, currency, or commodity is traded on two or more markets. For example, an arbitrageur simultaneously buys one contract of gold in the New York market and sells one contract of gold in the Chicago market, thereby making a profit because at that moment the price on the two markets is different.
<b>Basel Accords</b>	Issued by the Basel Committee on Banking Supervision (BCBS), a set of agreements which provides an international standard for capital adequacy rules. The name for the accords is derived from Basel (Switzerland) where the Basel Committee meets. The BCBS maintains its secretariat at the BIS. The first Basel Accord (Basel I) was issued in 1988 and the second Basel Accord (Basel II) in 2004. The Basel III is expected to be introduced in 2013.
<b>Capital Account</b>	An item in a country's balance of payments that measures the investment of resources abroad and in the home country by foreigners.
<b>Carry Trade</b>	The carry trade is a popular trading strategy used in the foreign exchange markets. The speculators buy high-interest-rate-bearing currencies and sell currencies with low interest rates. However, carry trade is a risky strategy because of uncertainty of exchange rates.
<b>Current Account</b>	This is a summary item in a country's balance of payments that measures net exports and imports

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	of merchandise and services, investment income and payments, and government transactions.
<b>Deleveraging</b>	A process through which investors reduce their financial leverage.
<b>Derivative</b>	A financial instrument whose value is contingent on the value of an underlying security. For instance, a futures contract or an option on a stock, stock index, or commodity.
<b>Fixed Exchange Rate</b>	A rate of exchange between one currency and another that is fixed and maintained by governments.
<b>Foreign Direct Investments (FDI)</b>	An investment in a country by foreigners in which real assets are purchased. These include real estate or plant and equipment assets and involve effort to manage and control. FDI flows have three components: equity capital, reinvested earnings, and other capital (intra-company loans as well as trade credits). FDI inflows are capital received, either directly or through other related enterprises, in a foreign affiliate from a direct investor. FDI outflows are capital provided by a direct investor to its affiliate abroad.
<b>Greenfield Investment</b>	When a transnational corporation opens a new facility in a foreign country as opposed to entering a market by acquiring an existing facility.
<b>LBOs</b>	The acquisition of another company using a significant amount of borrowed money to meet the cost of acquisition. Through LBOs, companies can undertake large acquisitions without having to commit a lot of their own capital. In a typical LBO deal, there is usually a ratio of 80% debt to 20% equity.

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<b>Leverage</b>	The use of borrowed money and other financial instruments (including derivatives) to increase the return of an investment. Leverage can be created through various financial instruments including options, futures and margin.
<b>London Inter-Bank Overnight Rate (LIBOR)</b>	The LIBOR is an interest rate at which banks can borrow funds from other banks in the London inter-bank market. Fixed on a daily basis by the British Bankers' Association, LIBOR is the most widely used benchmark for short-term interest rates.
<b>Off-balance Sheet Financing</b>	A kind of financing in which large capital expenditures are kept off of a company's balance sheet through various methods. Often companies use off-balance-sheet financing to keep their debt to equity and leverage ratios low.
<b>Petrodollars</b>	It refers to the profits made by oil exporting countries when the oil price rose during the 1970s, and their preference for holding these profits in US dollar-denominated assets. A significant portion of these dollars were in turn lent by Western banks to the developing world.
<b>Portfolio Investment</b>	An investment in a country by foreigners in which debt or stock ownership is involved. The result is a claim on resources, but typically no participation in the management of the companies involved.
<b>Prime Brokers</b>	A special kind of services offered to niche clients by large brokerage firms such as Goldman Sachs. The services provided under prime brokering include cash management, securities lending and leveraged trade executions.
<b>Real Sector</b>	The sector of economy in which people produce, trade and use goods and services.

<b>Securitization</b>	A structured finance process of turning an illiquid asset into a security. Mortgage-backed security is an example of securitization.
<b>Shadow Banking System</b>	It refers to financial intermediaries not subject to regulatory oversight involved in the creation of credit and other financial instruments across the global financial system. Before the onset of global financial crisis, the volume of credit intermediated by the shadow banking system was close to \$20 trillion.
<b>Sovereign Default</b>	It occurs when sovereign borrowers such as nation-states are unable or unwilling to pay their debt obligations. For instance, Argentina defaulted on \$1 billion of debt owed to the World Bank due to financial crisis in 2002.
<b>Special Purpose Vehicle</b>	A financial entity created for the purpose of fulfilling a very specific purpose and use. For legal and tax purposes, it is separated from the parent company. Usually, a special purpose vehicle is created to isolate the parent company from financial risk.
<b>Speculation</b>	The purchase or sale of stocks, bonds, commodities, real estate, currencies, derivatives or any other financial instruments to profit from fluctuations in their prices as opposed to buying them for use or for income derived from their dividends or interest.
<b>Spread</b>	The difference between the bid and the ask price of a security or asset.

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The financial crisis which erupted in mid-2007 has been widely viewed as the most serious financial crisis since the Great Depression of the 1930s. The crisis which originated in developed countries quickly spread to developing countries and the rest of the world. The turbulence in financial systems was followed by a significant reduction in real economic activity throughout the world. The crisis has highlighted that financial markets are inherently unstable and market failures have huge economic and social costs. The crisis has renewed debate on the role of global finance and how it should be regulated. The aim of this book is to encourage and stimulate a more informed debate on reforming the global finance. It examines recent developments and problems afflicting the global financial system. From a developing country perspective, it enunciates guiding principles and offers concrete policy measures to create a more stable, equitable and sustainable global financial system. Several innovative measures have been proposed to reform the global finance and to ensure that it serves the real economy.

**“The book is an outstanding contribution to the literature on global financial crisis. It is objective, sensitive, sensible, scholarly and yet eminently readable, with unique focus on developing countries. It should be a compulsory reading for policy makers and market participants.”**

**Dr. Y. V. Reddy, Governor, Reserve Bank of India (2003-08)**



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