Globalization of Financial Markets: Its Development, Indicators and Effects

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ملخص

عولمة الأسواق المالية: تطورها، مؤشراتها وتأثيراتها

لا شك أن القرن الحادى والعشرين هو قرن العولمة. وإن هذا التوجه فى الأسواق المالية له أهمية خاصة بالنسبة للباحثين ولمديرى الاستثمار ولصانعي القرار السياسي.

يهدف البحث بشكل عام إلى دراسة البيانات الإحصائية فى الأسواق المالية المختلفة وتقديم تحليل نظرى للتطور الحاصل فيها، وتوجيهها نحو العولمة خلال فترة ما بعد الحرب العالمية الثانية مع بيان التغيرات التى رافقت هذا التطور والتأثيرات التى يمكن أن تنتج عنها سلباً أو إيجاباً.

يرتبط تطور الأسواق المالية بالمتغيرات الرئيسية التى حصلت فى الهياكل المالية فى العالم. ويعتبر انهيار نظام النقد الدولى المسمى بنظام Bretton Woods عام ١٩٧٢، التغير الهيكلى الأول ونقطة التحول الأولى نحو العولمة. وتعتبر أزمة الدين الخارجي التي انتشرت آثارها فى أسواق المال عام ١٩٨٢ نقطة التحول الثانية فى نفس الاتجاه. وتبين الدراسة بوضوح هذا التوجه بدلالة مؤشرات التدفقات الرأسمالية، ورفع القيود عن القطاعات المالية، وتحرير التعامل فى أسواق المال الدولية، والابتكارات السريعة فى أساليب العمل المصرفى وأدوات الاستثمار المالى إضافة لمؤشرات الارتباط الإحصائى بين الأسواق المالية.

ولم يقتصر البحث على دراسة التوجهات العامة فى القطاعات المالية وإنما شمل أيضا دراسة وتحليل التغيرات فى الأسواق المالية المنفصلة، وبالتحديد أسواق الصرف الأجنبى، وأسواق التمويل المباشر وغير المباشر. حيث أظهرت الدراسة توجهاً إحصائيا واضحا نحو زيادة التدفقات الرأسمالية فى جميع الأسواق ولكن بدرجات متفاوتة مما يدل على التغير الحاصل فى مصادر التمويل الدولى خلال فترة البحث.

لقد أصبحت العولمة المالية بديلاً لنظام النقد الدولى بعد تعويم العملات الرئيسية فى العالم. ومن هذا المفهوم أصبحت العولمة التطور المالى الذى ساعد على استمرار صندوق النقد الدولى (IMF) ومنظمة الجات (Gatt)بعملهما. كما أن للعولمة المالية تأثيرات إيجابية تمثله بالمنافع المتوقعة منها، وسلبية متمثلة بالتكاليف المقدرة لها. وعلى هذا الأساس كان على السلطات المالية والنقدية أن تعمل على تعظيم هذه المنافع وتقليص التكاليف فى أى تطور مستقبلى لها.

تعنى العولمة المالية دوراً أكبر للأسواق المالية وتنافساً أوسع فيها، أملاً في تحقيق كفاءة أعلى فى استخدام الموارد المالية الدولية، وإذا كانت العولمة تعنى إلغاء القيود الوطنية على أسواق المال المحلية فلابد من الاستعاضة عن هذه القيود بإجراءات دولية لمراقبة وتوجيه قوى السوق الحر تجنباً لتعرض بلدان العالم لهزات مالية لا تحمد عقباها. لقد سلط البحث الأضواء على هذه الاحتمالات من خلال تحليل التطورات المالية التى حصلت فى أسواق العالم منذ عام ١٩٧٢ وتأثيراتها المتوقعة.

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(1) Introduction

Globalization means that financial markets around the world become interdependant; they do not operate independently of financial markets in other countries. Over the past several decades, international financial markets evolved with basic changes in the structure of finance as international conditions changed differently from one type of financial market to another. However, the event that triggered great interest in the globalization of financial markets was the "Crash of 1987". The collapse of the equity markets in New York Stock Exchange on 19 October 1987 was followed soon after by similar declines in major financial markets around the world such as London, Australia, Tokyo, Hong Kong, Singapore, Canada and New Zealand. The declines ranged from 19 per cent in Tokyo to 47 per cent in Hong Kong(1). Since most of these countries did not show any signs of problems with budget or trade deficits, the declines were attributed mainly to globalization of financial markets. In the words of a senior investment banker, "globalization is one of the catchwords of the modern corporate world. It definitely means bigger markets and tougher competition for industry and finance"(2).

The degree of interdependence among financial markets is of special significance for both researchers and investors, simply because of the implications and the far-reaching effects of globalization on economic policies and investment management. With increasing globalization, investment managers have to be involved in new technologies, innovations and instruments in global financial markets. Similarly the economic policy makers have to keep in mind that their policies are not limited to domestic financial markets anymore, and they have to work in economies increasingly linked through financial markets.

The main objective of this paper is to examine statistical evidence and study trends in different financial markets in an attempt to clarify how globalization has developed, what

indicators can be used for measuring it and what possible effects it could have on financial management and economic policies, exploring at the same time new areas for further investigation.

To accomplish this objective, the paper following the introduction is divided into four sections. Section II is devoted to a review of historical development of financial markets in general during the past fifty years in addition to a discussion of trends in the three major types of financial markets, namely, foreign exchange markets, indirect financial markets and direct financial markets. Section III deals with certain changes that have occurred in financial markets and have led to or are associated with globalization such as changing technology and innovations, increasing number of financial instruments, correlation between financial indices in different markets and deregulation of domestic markets. Possible and expected effects of globalization are discussed in section IV and summary and conclusions are given in section V.

For the purpose of this paper, the following terminology is important since most capital markets have this structure and a clear distinction should be made between domestic market, foreign market and external or "offshore" market.

- Domestic or national market is a market with unique procedures, laws and institutions stemming from historical and regulatory determinants. Residents of the country only participate in national markets. Foreign market is usually attached to the national or domestic market where non-residents supply and demand funds, but always under the specific rules established for foreign participants in the national markets.
- External or "offshore" markets are located in a different political jurisdiction and only linked to the national market by the currency used to denominate the financial claims. For example, markets for dollar-denominated loans, deposits and

securities outside the jurisdiction of the U.S. are considered external or offshore markets.

(2) The Long-Term Development of Global Markets

In discussing the development of global financial markets, researchers put special emphasis on the last two decades of the 20th century[3]. However, to put this development in the right historical economic perspective, a longer period should be taken into consideration.

The shift in financial markets from domestic (national) markets to global markets is believed to be associated with major changes in the world's financial structure during the past fifty years, namely, the break-down of the Bretton Woods monetary system in 1972 and the external debt crisis in the early 1980's. Therefor the following three periods maybe distinguished in the historical development of global markets.

(2-1) The Bretton Woods Era (1946-1972) was a period of national markets during which the prevailing concepts were free trade, pegged but flexible exchange rates, and development finance through multilateral organizations. (GATT, IMF and World Bank). Financial flows were mostly restricted to intergovernmental rrangements or ehabilitation nd ebuilding of economies that were destructed in World War 2. The role of the banking system was confined only to transferring funds for meeting developmental and trade finance requirements.

In general, it was a period of steady growth, low inflation, aggregate demand management, and trade off between unemployment and inflation. Credit markets and interest rates were highly regulated by governments. Capital markets were poorly developed and national both in scope of operation and purpose.

During this period financial markets in different countries were independent of one another, constrained by exchange

controls and limited by regulations governing financial products innovations, financial instruments and market access.

(2-2) The Post Bretton Woods Era (1973-1983) was a period of internationalization of capital markets. The break-down of the Bretton Woods monetary system marked the end of an era and the beginning of a new one when the U.S. declared the floating of the dollar and that it was no longer convertible into gold. By 1973 the efforts to fix exchange rates between the dollar, the pound, the mark and the yen were abandoned, leading to generalized floating of exchange rates, and increasing foreign exchange risk.

The main features of this period were rising oil prices, stagflation and interest rates as high as 20 per cent. It also witnessed the rapid development of a large and mostly unregulated, off-shore (external) capital market: the Euro market. Through this market, national capital and credit markets were now linked. London became the home for hundreds of banks and securities companies from all parts of the world, partly because of its favorable location between New York and Tokyo, and partly because of regulations allowing this off-shore market to exist.

(2-3) Global Markets Era (1983-present). In view of rising interest rates and increasing risks from exchange rates instability, gradually in country after country, interest rates were deregulated, capital markets liberated and foreign institutions were granted increased access to hitherto protected markets. The international financial system was becoming a multinational or global system where capital flows directly and in greater quantities from one country to another.

The outstanding event in this period was the world external debt crisis of the early 1980's, accompanied by lower inflation and falling interest rate. Together, these changes led to rapid innovations in banking, more sophisticated financial instruments,

- Loans made to governments, businesses or citizens by a bank operating in a foreign country in either home currency or currency of the foreign country, (location factor).
- Loans made to governments, businesses or citizens by a national bank in foreign currencies; for example a loan is made to a Jordanian citizen by, a Jordanian bank not in dinars but in dollars, (currency factor).

Markets for indirect finance witnessed some severe changes during the last three decades of the 20th century. With rising oil prices and increasing funds flowing from oil exporting countries to industrial countries in the 1970's, growth in financial markets shifted markedly toward intermediated loans particularly to developing countries. International lending by banks exploded and major international banks became the primary creditors of developing countries[6]. According to the Bank for International Settlements, lending rose from $8.8 billion in 1972 to $ 103.6 billion 10 years later. However, after the 1982 external debt crisis, total bank lending, according to IMF sources, declined from $ 265 billion in 1981 to 125 billion in 1984. The decline was most noticeable during the 1980's, because banks began to renew their interest in lending to developing countries in the early 1990's and reached $349.7 billion in 1996[7].

Nevertheless, the growth in international bank lending was overshadowed by greater growth in direct finance, namely, in international issues of securities and derivatives instruments. In fact, the troubles commercial banks encountered in the mid-1990's were believed to be a direct outcome of this shift in international finance.

(2-3-3) Markets for Direct Finance: Bonds. Equities and Derivatives

The significant shift in financial markets from indirect finance that had started after the external debt crisis in 1982 showed its effect first in the international bond markets in the

early 1980's, followed by the cross-border equities markets in the mid-1980's and finally in the derivatives markets in the late 1980's.

Markets for international bonds have no central place. Investors are worldwide and bonds are traded by a network of dealers connected by modern technology.

Statistics show the growth of international bonds (Euro-bonds and foreign) from $150 billion in 1982 to $708.8 billion in 1996[(8)]. As a source of finance and for the purpose of diversification U.S. investors, for example, have found international bond markets increasingly important to them and so have foreign investors in U.S. markets.

Since the mid- 1980's the line between debt and equity started to fade. The supply of and demand for, convertible bonds and bonds with warrants giving a right to equity of the issuer grew significantly. Nevertheless, compared to the international markets for bonds and loans, the market for cross-border equities began to grow dramatically and achieve significance only in the mid- 1980's. Here again, investors sought to diversify their risk across international borders.

Accurate data about cross-border equity are difficult to find, partly because foreign equity investment has two main channels:

- The purchase or sale of an equity security on a stock exchange local to the issuing company for the benefit of a non-resident investor.
- The purchase or sale of a foreign equity on a stock exchange local to the investor.

Therefore, a noticeable difference between the volume of equity offerings and trading is observed. For example, international equity offering increased from $20.4 billion in 1987 to $58.1 billion in 1994, whereas, IMF reported an increase in

cross-border equity trading (trading = all purchase + all sales of foreign equity) during the same period from $508.6 billion in 1987 to $2000 billion in 1994[9].

The growth in derivative products (swaps, futures and options) has been perhaps the most remarkable feature of international financial markets in recent years. Derivative markets allow parties to take positions on the future value of many financial commodities such as stocks, bonds, interest rates and exchange rates. This in turn allows investors to hedge or speculate with great particularity by isolating, pricing and managing risk across many financial markets.

Even though, growth in these markets started later than in other financial markets, derivatives markets have grown rapidly since the late 1980's, so that nominal values of trading in these markets are in the trillions of dollars. The annual turnover of exchange traded derivatives exceeded $16 trillion in the year 2000 as compared to only $389 billion in 1987, and over the counter trading amounted to more than $90 billion[10]. This rapid growth maybe explained partly by the fact that investors are often able to take positions in the derivatives markets using relatively little of their own money. However, the actual risk in taking such positions is difficult to quantify, because price movements in the derivatives markets may affect prices in the underlying markets for credit or currencies. In fact, some policy makers fear that derivatives markets destabilize other financial markets and increase systematic risk[11].

(3) Indicators of Globalization

What are the changes that have been associated with trends in international financial markets and can be considered as indicators of globalization? This is the main question that will be addressed in this section without going into the empirical question of whether these changes are causes or outcomes of globalization.

One can easily point out several important changes that have been connected with the globalization of financial markets in one way or another, but it is not so easy to categorize them into separate entities. Liberalization, deregulation, innovations, shifts in capital flows, increasing financial instruments and correlation between financial markets indices are all changes associated with the globalization of financial markets but one cannot draw a clear dividing line between liberalization and deregulation or between innovation and increasing financial instruments or between deregulation, changes in capital flows and correlation of financial indices in various markets. Nevertheless, for a clear discussion of the indicators of globalization, these changes will be dealt with separately.

(3-1) Liberalization and Deregulation

Liberalization of financial markets means making the financial system more dependent on market forces by reducing governmental regulation, but it does not necessarily mean the absence of regulation; indeed it may need some regulatory framework for directing the liberalization process toward its aims.

Of course the main aim of liberalization and deregulation is the achievement of greater efficiency in the financial markets. After the break down of the Bretton Woods system, a great need for liberalization and deregulation arose in industrial countries. Country after country started deregulating their financial markets to enable banks and financial institutions cope with the changes in the international monetary system, particularly the greater volatility of exchange rates and the efficient use of capital flows and savings.

Deregulation involved a great variety of measures that varied in nature and scope among countries[12].

In general they included:

- Less direct controls of interest rates and foreign exchange. Allowing commercial banks to buy and sell securities.
- Reducing or removing barriers to foreign participation in domestic markets.
- Allowing the use of new financial instruments such as floating rate notes, zero-coupon bonds and interest rates and currency swaps.
- Allowing the use of bonds denominated in different currencies particularly the German Mark and the Japanese Yen.
- Abolition of restrictions on capital flows and international financial services.

It is worth noting here that the increased competition in financial markets that was associated with liberalization and globalization in industrial countries induced deregulation and liberalization in developing countries which enhanced greater private capital flows to them. During 1995-1996, 86 percent of private capital flows to developing countries was concentrated in Latin American countries, South East Asia and Turkey, while the Middle East and North Africa accounted for only 4.4 percent(13). The difference between the two groups of countries is believed to be due to the difference in the scope of liberalization.

(3-2) Correlation between Financial Markets

With greater capital mobility, a higher correlation is expected between changes in prices, returns and indices in different financial markets. This correlation is of interest to both investors and researchers, because low correlations imply that substantial benefits can be achieved through international diversification.

The crash of the New York stock market in October, 1987 and its repercussions in other international financial centers is certainly a clear indication of some degree of correlation among

different financial markets. This matter has been the subject of many statistical investigations and often considered to be an indicator of globalization of financial markets. Aggarwal and Rivali confirm in their study that the stock markets in four Asian countries have a tendency to follow New York and conclude that the effects of the New York crash were not unique [14]. Jaffe and Westerfield compare pattern of change in stock prices in five industrial countries, the USA, Canada, Australia, the UK and Japan. They confirm that there is a striking similarity between mean returns on stock on different days of the week in the five markets[15].

However, in spite of the fast technological progress that has been achieved in the field of telecommunication, a significant difference is found in degree of correlation among different groups of countries. For example, correlation among Asian markets or among European markets is higher than correlation between Asian and European markets. Thus, it is suggested that correlation among financial markets depends on the level of development and the degree of interdependence of their economies in addition to capital mobility.

(3-3) Increasing Financial Instruments

Another major feature of globalization is the increasing number of financial instruments that have become available to both borrowers and investors during the past quarter century. Before the collapse of the Bretton Woods monetary system in 1972, international financial instruments were limited to convertible and straight bonds mostly denominated in U.S. dollar, D-Mark nd wiss ranc n he uro-bond market. Maturities tended to be long and U.S. dollar convertibles dominated the markets.

The rapid increase in financial instruments in the form of new types of bonds, foreign equities and derivatives started after the crash of the U.S. dollar and the world financial community

realized that the system of fixed exchange rate with bandage could not be taken for granted anymore. The increased volatility of exchange rates necessitated the finding of new instruments suitable for hedging against such risk, and the deregulation of financial markets facilitated the use of such instruments by foreign participants [16]. Transactions in foreign equities, bonds and all types of derivatives increased at a very rapid rate and the development of financial centers in the Far East (Hong Kong, Singapore and Tokyo) helped in achieving greater diversification in international capital markets.

(3-4) Financial Innovations

Financial innovations include changes in types of financial instruments, financial services and techniques or the way these services are rendered. The process of innovation has certainly played a significant role in the development of globalization of financial markets. The three features of globalization that are discussed in this paper are connected in one way or another with the process of innovation in financial markets.

"Spurts of financial innovation, such as that experienced during the 1980's can have several causes: changing needs for financial services, new communications and information technology, inflation and high interest rates, volatility in financial markets and regulation of the financial sector. These elements can operate independently or occur simultaneously causing them to feed upon each other"[17]. When applied to the development of globalization of financial markets, substantial evidence can be found confirming the validity of these causes. For example, during the period (1973-1983) that followed the collapse of the Bretton Woods system stagflation and high interest rates prevailed which made investors aware of the high opportunity cost of holding balances not invested at market rate. New financial products such as cash management accounts and money market mutual funds were developed to cover the risk of unexpected inflation and rising interest rates. Also the period

witnessed the rapid development of an unregulated off-shore capital market which served the need for escaping domestic market regulations motivated by profit maximization and more efficient use of funds. The escapable regulation naturally becomes redundant in such cases and gives a good reason for its removal and thus allowing for more innovation. Similarly, as a result of the world external debt crisis of 1982, the decline in bank lending, and the increased volatility of exchange rates, a new type of innovation took place in financial markets in the form of more sophisticated financial instruments that were capable of transferring risk such as interest rate and exchange rate swaps, futures and options, and the enhancement of off-balance sheet banking. All these innovations were supported by new communication and information technology that also played an important role in the development and expansion of new financial centers in the Far East, reduce the cost and increase the speed of financial transactions.

(4) The Expected Effects of Globalization

Whether globalization of finance is good or bad is the subject of debate worldwide. No one can deny that globalization provides increasing opportunities for innovation and investment. It gives investors greater latitude in managing their risks through diversification in a global capital market. As a matter of fact, this trend toward the globalization of finance may be considered the crucial development that saved the IMF and GATT (later WTO) arrangements after the break down of the international monetary system.

The expected effects of globalization maybe good or bad. Globalization holds the potential for a lot of benefits, but at the same time it increases costs that must be taken into account. Therefore, the argument about the effects of globalization should be centered around two basic questions:

- Do the costs of this fast growing trend outweigh the benefits?

- How can the world minimize the costs and maximize the benefits?

The answer to these questions, no doubt, includes some theoretical and empirical aspects that can be the subject of separate studies, and would involve some normative judgement in comparing benefits with costs. Therefore, our aim in this section is limited only to the discussion of the possible expected costs and benefits of globalization.

(4-1) Benefits:

a- To the extent that globalization increases capital mobility on worldwide basis, it allows both private and public sectors to finance their projects and obtain better financial services at a lower cost due to greater access and more competition. German citizens can invest savings in French stocks and vice versa, which is a major objective of financial integration in Europe. Koreans could raise funds in Japanese markets for investment in Korea or elsewhere that Korean savings were not adequate to finance.

b- For developing countries, globalization provides for a more flexible link between consumption and savings and breaks the rigid ties between domestic savings and investment. Jordanian companies can borrow from UK citizens to finance investment in Jordan without putting pressure on Jordanian consumption. This can enhance investment and help in achieving faster economic growth and higher standards of living in Jordan.

c- As a result of 1982 world debt crisis, bank lending was sharply curtailed and many developing countries continued to encounter difficulties in servicing past debt in the mid-1980's. With greater economic liberalization, more interest has been directed to increasing foreign private investment as a measure of development finance [18]. Today, almost all big companies of different nationalities are operating on global scale, investing in manufacturing and service facilities all

over the world, and transferring technology and managerial known-how beyond their national borders. Even though the benefits of foreign direct investment as a substitute for development assistance are debatable, it does possess some advantages over borrowing. By easing constraints on external financing, globalization can be a driving force in increasing capital flows in the form of direct investment [19].

d- Since capital flows in a competitive market are usually ruled by higher returns on capital, globalization of financial markets definitely can promote a more efficient allocation of resources on global basis and thus help in achieving faster economic growth.

e- Globalization of financial markets certainly requires countries that want to benefit from global financial resources to reform their financial systems and develop efficient financial markets that are capable of competing for excellence. In other words globalization encourages the development of financial markets. Such markets, aside from being an important tool of economic development, they can play a very important role in the process of privatization. In two case- studies of financial markets in the ESCWA region, "the conclusions on the role of the financial markets in privatization in Egypt and Jordan have shown that this role is not totally different from their role elsewhere in the developing countries. Being still in their early stages of development and having a number of weaknesses, financial markets in both countries are not expected, at least in the short-term, to be fully capable of playing the role envisaged for them in privatization, such as facilitating proper equity valuation and offering a channel for widespread distribution and subsequent trading of claims"[20].

(4-2) Costs of globalization:

The costs of globalization represent the negative effects that are associated with the development of globalization. These

effects will be discussed under two main headings: first, the new types of risks that have been generated by financial globalization, and second, the decreased autonomy of national economic policies.

(4-2-1) Risks of Financial Globalization:

a- Financial globalization could lead to greater systematic risk on international level. Failure of a large bank in a big economy such as the U.S. for example could initiate a series of bank failure in other countries. On the other hand a major financial disturbance in a smaller country with heavy foreign investment could pose a big threat to the lending or investing banks in other countries.

b- Financial markets and economies are not politically and economically matched. Economies that perform comparatively well would attract surges of capital inflows, while poor performing economies would not only experience reversal of foreign capital flows but would also lose domestic capital. In both cases, globalization becomes a big challenge to macroeconomic stability. What happened in Mexico and Thailand in the 1980's and in Korea in 1990's is an example of such threatening instability.

c- Capital is known to be "coward". When international investors suffer losses in one country or when a country adopts policies that are not favorable to foreign investment, investors could lose confidence in the policies of other countries specially developing countries with weak financial sector and poor bank supervision. Investors tend to overreact and that would lead to "spillover effect" as in the cases of Argentina in 1995 and Indonesia and the Philippines in 1997.

(4-2-2) Autonomy of National Economic Policies:

In addition to the costs of increasing systematic risk, instability risk and spillover risk, countries that are open to financial globalization have to realize that their economic policies become less autonomous. It becomes harder to manage

money supply, interest rates and foreign exchange rate, while tax policies and financing government expenditure could have repercussions on international level.

With globalization there is a greater role for financial markets to play in attaining a stable equilibrium of interest rate, exchange rate and money supply. Monetary authorities have to decide which one of the three variables should be targeted by monetary policy. If the exchange rate is anchored, the money supply and interest rates are not easy to control. If the exchange rate is flexible, then choosing a monetary policy target depends on which instrument is more effective in attaining economic stability.

Under a nominal exchange anchor policy, monetary restraint to reduce inflation, for example will push up interest rates and induce capital inflows that increase inflationary pressures and an appreciation of the real exchange rate. The appreciated exchange rate reduces competitiveness and leads to external imbalance. If financial markets overreact to this imbalance, maintaining the nominal exchange rate through financial exchange rate intervention may prove to be ineffective or outright impossible as have been witnessed in Mexico and Thailand.

Under flexible exchange rates, monetary policy could have greater autonomy by enhancing the role of the exchange rate and reducing the role of interest rate in achieving monetary policy objective because more adjustment could come through the exchange rate. However, greater volatility of exchange rates could have some undesirable effects on international trade in the form of increasing cost as a result of increasing exchange rate risk. Moreover, authorities are usually reluctant to accept high volatility in exchange rates and abandon a nominal exchange rate anchor policy because of their concerns about the effects of such

volatility on the banking system, the demand for money and the outflow of capital.

(5) Summary and Conclusions

Researchers, financial managers and economic policy makers are all concerned with globalization of financial markets. With increasing globalization, investment managers face new challenges, policy makers have to take into consideration factors outside their domestic markets, and researchers must keep investigating all possible trends and effects of globalization in order to help both managers and politicians in taking appropriate decisions. The objective of this paper is to study statistical trends in different financial markets and to give a theoretical analysis of the development of financial globalization, the changes that have been associated with it and benefits and costs that may evolve in the process.

Trends in the development of financial markets can be connected with major changes in the world's financial structure. Three periods are distinguished in the long-term development of these markets during the past fifty years: the Bretton Woods Era (1946-1972), the post Bretton Woods Era (1973-1983) and the Global Market Era (1983-present). The two landmarks in this development are the break down of the international monetary system in 1972 and the international debt crisis in 1982. The review of historical developments shows a clear trend toward globalization in terms of greater capital flows, deregulation of financial sectors, liberalization of capital markets, rapid innovations in banking techniques and financial instruments and greater correlation among financial markets.

To give a clearer picture of this development, statistical trends on lower level of aggregation were studied and theoretically analyzed, specifically, in the foreign exchange market, the indirect finance markets and direct finance markets, The statistics reveal the explosion of foreign exchange markets

(spot, forward and swaps) as far back as the mid- 1980's, surpassing the growth of the world GDP and trade. This can lead to the conclusion of rising speculation and greater need for risk hedging. Speculation can have a destabilizing effect if it leads to greater exchange rate volatility.

Indirect finance markets went through some severe changes during the past three decades. International lending by banks increased dramatically during the 1970's, declined sharply during the early 1980's particularly after the external debt crisis, and regained some of its growth in international finance in the early 1990's. However, it was overshadowed by greater growth in international securities and derivatives.

Direct finance markets which include bonds, equities and derivatives markets showed a very rapid growth starting with bonds market in the early 1980's followed by cross-border equities and derivatives in the mid- 1980's and late 1980's. The growth in derivatives has been the most remarkable of the three. It can be explained partly by the fact that investors are able to take positions in the derivatives markets using relatively little of their own money. However, price movements in the derivatives markets could affect prices in the underlying markets and thus may have destabilizing effect and increase systematic risk.

In addition to increasing size of international financial markets, several important changes have been associated with globalization. They are grouped into four types, even though they are very much interconnected. Correlation between financial market indices depends on the level of market development and the degree of interdepence of their economies which in turn depends on the nature and scope of liberalization and deregulation in those economies. Another feature of globalization is the remarkable advances in financial innovation, which could not have been achieved without the changing communications and information's technology on one hand and

the liberalization of markets on the other. Also the substantial increase in the number of financial instruments after the collapse of the Bretton Woods monetary system would not have been possible without suitable financial innovation and technological change.

In the wake of this collapse, globalization of finance is considered the crucial development that saved the IMF and GATT arrangements. However, other effects of globalization maybe good or bad. Several possible benefits are discussed in the paper along with possible costs in the form of increasing systematic and instability risks and less autonomy of national policies. Evaluation of these benefits and costs would certainly involve some normative judgement, but authorities should keep looking for ways and means that maximize benefits and minimize costs.

Globalization definitely means greater role for financial markets and greater competition, but absolute freedom of market forces could miss the target on international level just as they do on domestic level. There are factors that make "free" markets deviate from reaching an optimal solution and call for intervention to put market forces in the proper direction. National constraints have been eased or abolished and need to be replaced by international monitoring and guidance with the aim of minimizing costs and maximizing benefits of globalization.

Notes and References

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