

**IDEAs Conference on  
Re-regulating global finance in the light of the global crisis**

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**Finance and the real economy**

**Hello global financial crash! Good-bye financial globalization?**

**Draft for comments**

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“... When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done. The measure of success attained by Wall Street, regarded as an institution of which the proper social purpose is to direct new investment into the most profitable channels in terms of future yield, cannot claimed as one of the outstanding triumphs of *laissez-faire* capitalism ...”

John Maynard Keynes<sup>2</sup>

There is some sort of poetic (but costly) justice regarding the current global financial crisis which started with the sub-prime mortgage crash in the United States (US). The experience of many developing countries since the mid-seventies demonstrates how the financial instability caused by the liberalization of domestic financial markets and international capital flows can lead to failed development. The eighties is remembered in Latin America as the “lost decade”, because of the consequences of the drastic external and budgetary adjustment undergone by most countries in the region, as a result of the debt crisis which started in 1982 with the Mexican moratorium. More recently, the impact of the emerging markets financial crises in countries as diverse as Argentina, Indonesia, Mexico, Russia, Thailand, and Turkey, to name a few, have also been very dramatic.

However, rich countries and multilateral credit organizations ignored the lessons taught by these crises, chose to believe that financial liberalization had little to do with them and instead blamed the victims for their corruption, lack of transparency, poor governance, crony capitalism, fiscal irresponsibility, and populism, that is to say, all the features you might expect in the caricature of a typical Third World country but never in a developed economy.<sup>3</sup> Moreover, it was suggested that in order to preserve financial liberalization and prevent new crises, emerging economies should copy the accounting standards, prudential regulation and supervision procedures of the US. Indeed, the US

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<sup>1</sup> CONICET-University of Buenos Aires.

<sup>2</sup> Keynes (1936), page 159.

<sup>3</sup> Krugman (1999) was one of the few and first to read an early warning in these events for the whole world.

and the European Union had their share of financial crashes and scandals in the 1990s but since they were mild and shortlived, they were quickly forgotten. No wonder the current crisis has caught rich countries off guard and has humbled and perplexed them.

It is a cliché to say that crises are opportunities, but this is certainly the case today. For the first time in a long time (perhaps, ever), developing countries have a chance to discuss with developed countries how to restructure the international economic order. The theme and questions of this conference are a good starting point. But before addressing them, let me go over a bit of history.

### Financial globalization: an unexpected development

One of the assumptions the Bretton Woods institutions were built on was that the global capital market which prevailed during the Gold Standard era, was gone for good. Consistently, when the International Monetary Fund (IMF) set the goal of restoring current account transactions convertibility, it left aside the issue of capital account convertibility. Furthermore, the International Bank for Reconstruction and Development, better known as the World Bank, was founded to finance the European post-war reconstruction. Nobody expected international private capital flows to do the job. Eventually, the Marshall Plan provided the cash for the task and the World Bank turned to a new mission: financing the development of the so called backward countries, the new international actors which emerged from decolonization amid the Cold War.

On the other hand, domestic financial markets were subject to many regulations, both in developed and developing countries. For instance, in the US the Glass-Steagall Act built a wall between investment and commercial banking while regulation Q banned interest rates on demand deposits and set caps on saving and time deposit interest rates. In the developing world, extensive interventions in financial markets played an important role in the East Asian miracle (Stiglitz and Uy, 1996).

However, a growing offshore Eurocurrency market developed in the sixties, once current account convertibility was restored. Thus, the seed of the last wave of financial globalization was sown. The process was accelerated by two important events, which occurred in the mid-seventies: firstly, the demise of Bretton Woods fixed exchange rates regime, secondly, the first oil shock. Indeed, the move to floating exchange rates was a consequence of (among other factors) the speculative attacks on “weak” currencies, made possible by the development of the Eurocurrency market. The recycling of petrodollars triggered a new phase of sovereign debt borrowing among developing countries, especially, in Latin America (Frenkel, 2001).

### Financial crises: unsurprising events

In the late seventies and early eighties, the military dictatorships of the Southern Cone countries, i.e. Argentina, Chile and Uruguay, borrowed heavily from foreign banks to fund neoliberal stabilization and reform programs, which became true forerunners of the 1990s’ Washington Consensus. One of the pioneering reforms they undertook was the liberalization of domestic credit markets in order to end “financial repression,” following the recommendations of McKinnon and Shaw. Exchange-rate based desinflation combined with trade and capital account liberalization proved disastrous as the resulting currency and financial crises led to economic depression. The title of this

paper was inspired by Díaz-Alejandro's (1985) well-known account of this story: "Good-bye financial repression, hello financial crash". In the mid-eighties all economists (Latin American heterodox, mainstream academics, orthodox IMF officials) reached a consensus on the lessons to be learned from the Southern Cone experience: financial liberalization should not be implemented at the beginning of a reform program or combined with exchange-rate based stabilization (Frenkel, 2003).

In the fall of 1979, the US Federal Reserve shifted from a loose to a tight monetary policy in order to fight the ongoing inflation and the impact of the second oil shock. The shift marked the official debut of Milton Friedman's monetary growth targets. The implementation of the new policy regime included the removal of the caps on deposit interest rates to reinforce the transmission mechanism. Similar developments took place in Great Britain under Margaret Thatcher's rule. The rise of Margaret Thatcher and Ronald Reagan started the "Conservative Revolution" and probably the era of financial globalization.

The subsequent increase in US interest rates, which was further fueled by Reagan's increased budgetary deficits, caused a serious world recession and triggered the international debt crisis in 1982 as developing countries had borrowed at variable interest rates. Faced with double-digit real interest rates, falling export prices, domestic capital flight and the suspension of foreign credit, many developing countries were forced to undergo drastic adjustments to meet their foreign debt obligations. The 1980s international debt crisis was another demonstration of the dangers posed by unfettered international financial markets to developing countries.

Higher interest rates in the US and the UK triggered capital outflows in European countries, which had to choose between the inflationary pressures of currency depreciation (amidst the second oil shock) or a contractionary monetary policy. They chose the latter and European unemployment rates jumped from one to two-digit levels. This illustrated the fact that the proclaimed isolating properties of floating exchange rates were an illusion (Tobin, 1978).

The Southern Cone and the international debt crisis lessons were soon forgotten in the 1990s when the US Treasury and the IMF pushed hard and successfully for financial liberalization. "Emerging markets" became fashionable as many developing countries, especially, those that had suffered most under the international debt crisis, implemented the Washington Consensus reforms, during a period of low interest rates in the US. Recognition of East Asian miracles also helped to channel huge amounts of capital inflows into the region. The IMF tried to change its charter in 1998 in order to impose capital account convertibility. No wonder a new round of financial crises befell the developing world. In 1994, a new tightening in the Fed's monetary policy triggered the Mexican Tequila crisis. The aftershocks were felt everywhere. "Contagion" became the buzzword. In a few years, East Asian miracles turned into crises, reformed Russia imposed a moratorium; Turkey and Brazil faced painful currency depreciations (Frenkel, 2003). Finally, Argentina, a country highly praised in the 1990s by the international financial community, announced the largest default in the history of international finance.

Developed countries also made great strides towards financial liberalization. For example, the European Union removed capital controls and deregulated financial

markets before the launch of the euro, and the Glass-Steagall act was repealed in the US in 1999. But deregulation and weaker supervision was not the whole story. Financial innovation introduced a bunch of products and transactions which were unregulated, especially, derivatives. The US witnessed several crashes: the 1987 stock market crash, the fall and rescue of Long Term Capital Management, the burst of the Internet bubble and the aftermath of the Enron scandal and, finally, the subprime mortgage crisis.

### The roots of the problem

Keynes's quotation at the beginning of this paper states the nature of the problem: free financial markets may become a casino. Why? Because "... of the extreme precariousness of the basis of knowledge on which our estimates of prospective yield have to be made" (p. 153), as "... the organisation of investment markets improves, the risk of the predominance of speculation [over enterprise] does however, increase." (p. 158). By speculation, Keynes meant the activity of forecasting the psychology of the market [to obtain a short-term gain], and by enterprise he meant the activity of forecasting the prospective yields of assets over their whole life [to obtain a long-term gain] (p. 158). "These tendencies are a scarcely avoidable outcome of our having successfully organised 'liquid' investment markets" (p. 159). So, speculation brings instability, which is compounded by *animal spirits* (pp. 161-162). This instability leads to manias (speculation), panics and crashes, as thoroughly documented by Kindleberger's (1978) classic work on financial crisis based on Minsky's restatement of the Keynesian argument.

In Tobin's (1978) words, the "basic problems are these. Goods and labor move, in response to international price signals, much more sluggishly than fluid funds. Prices in goods and labor markets move much more sluggishly, in response to excess supply or demand, than prices of financial assets, ...". On the other hand, in "the absence of any consensus on fundamentals, the markets are dominated ... by traders in the game of guessing what other traders are going to think." "In these markets, as in other markets for financial instruments, speculation about future prices is the dominating preoccupation of participants."

What triggers a mania (speculation)? A "displacement" that is to say, an exogenous shock such as: a war, the end of a war, a series of bad harvests, a series of good harvests, the opening of new markets, innovations, etc. In later editions of his book, Kindleberger added financial deregulation or liberalization to the list. Stiglitz (2002) also relates these crashes not only to financial deregulation or weak supervision, but also to the deregulation in the telecom and energy industries.

More specifically, Boyer (2008) argues that the series of bubbles and crashes that happened in the last two decades are explained by the introduction of financial innovations since the early 1980s that involved a new method of equity portfolio management which associated any transaction with the purchase of an option intended to prevent an expectation error. Simultaneously, all market agents are endowed with software that allows them to place directly the orders implied by its optimization program. In case of a marked fall in stock market prices, a depressive spiral is started: everybody wants to sell nobody wants to buy. The generalization of risk hedging has precipitated the realization of the risk, which the agents' microeconomic plans attempted to prevent: the aggregation of these rational microeconomic strategies lead to

the suspension of the market. This feature has occurred in most crashes since 1987, including the subprime mortgage crisis (p. 21).

This is a remarkable result: an instrument designed to reduce the risk exposure of individual investors actually raises market instability. In turn, this instability is compounded by the huge leverage of hedge funds. Besides, keeping apace of financial innovation is not an easy task even for willing regulators.

In the case of developing countries, financial crashes often involved foreign capital flows and end up in currency crises, causing even more damage, as is well known. On the other hand, they have a much harder time in coping with the challenges posed by a global financial market with the features described.

From a broader perspective, the main problem with financial (as well as with other dimensions of) globalization is the huge gap between the highly developed global market and the undeveloped global polity. Meyerson (2008) has purported that the regulation of the new brave world of finance should be global.

True, we have the Bretton Woods institutions (though without the Bretton Woods regime), but due to their plutocratic and oligarchic governance structures, they are a far cry from a global polity, especially, a democratic one. Certainly, this is not an isolated fact but a reflection of the democratic deficits of the United Nations system, to which they belong. Therefore, a discussion of global reform proposals should probably start with the UN system itself.

Nevertheless, the goal of global participatory institutions directed to regulate the global economy poses a formidable challenge. Note that the main realm of participatory politics lies within the limits of the nation state. When most market transactions take place among residents of the same country, national regulation of domestic market failures by a democratic government is all that is needed: the extent of the market is congruent with the scope of government. However, when, as in Keynes words, “economic entanglements between nations” grow in importance, the solution of market failures involves international relations issues. It becomes much harder to find democratic answers given the glaring asymmetries and inequalities in terms of economic, political and military power among nations. Most likely, superpowers will have their way: they will capture the bulk of the benefits from globalization and impose sizable costs on other countries.

This tension is illustrated by Polanyi-Rodrik’s “political trilemma of the global economy”: the nation state, democratic politics and deep economic integration are mutually incompatible. At most, we could get two out of three of them (Rodrik, 2002, 2007). The Bretton Woods regime, which set clear limits to international economic integration, allowed for the spread of democracy, the implementation of the Welfare State, and the largest economic boom in history; the nation state and participatory politics prevailed at the expense of deep economic integration giving shape to what Ruggie (1982) called “embedded liberalism” as opposed to the classical liberalism of the Gold Standard and Pax Britannica.

The nineties witnessed the rule of the global market. Deep economic integration advanced at least at the expense of democracy, if not nation states, as central banks

independence became dogma, WTO was born and the IMF exerted unprecedented leverage in the developing world. Eventually, popular reactions burst in Argentina, Bolivia, Ecuador and Indonesia, overthrowing the governments which prioritized international economic integration.

To make deep economic integration compatible with democratic politics, some sort of Global Federalism, as Rodrik calls it, would be necessary. That is somehow the road chosen (at a much smaller scale) by European Union members, though not without hurdles as shown by some reactions to the draft of the European constitution. True Global Federalism, however desirable it might be, is quite far from the foreseeable future. What can we do in the meantime? Perhaps, take a more piecemeal, gradual approach to international integration.

### Financial globalization or development finance?

The key issue of interest for developing countries is not really as much how to design or improve a global regulatory framework for financial flows as it is how to recover the control over domestic policies and mobilize domestic resources for the successful implementation of development strategies. A remarkable fact in the last quarter of century is the vanishing of financing for development as one of the key themes of international economic policies and as a main goal of multilateral credit organizations. In other words, a better framework for global finance is the agenda of the rich countries which still pivots on the liberalization of capital markets. The agenda of middle-income and low-income countries is the mobilization of (domestic and foreign) resources for development.

The agenda of the rich assumes that it is possible to develop a unified global framework for financial stability based on technical standards, information disclosure and prudential regulation, while maintaining unfettered capital markets. The catchphrase here is “good governance.” There are two problems with this view. Firstly, as Stiglitz (2004a) puts it, good governance does not eliminate the information imperfections, or the irrational expectations which underlie financial market failures. Secondly, as Rodrik (2002) emphasizes, national regulations are embedded in the society at large and reflect domestic political compromises. The international standardization<sup>4</sup> of regulations have thus a limit when there is no global democratic polity. North (1994) makes a similar point when he warns that institutions do not travel well across countries as they are the result of history, of gradual and cumulative change. North specifically warns transition and developing economies against copying the developed countries’ legal and regulatory frameworks. This is not to say that efforts to improve prudential regulation should not be pursued. Our point is that from a developing country perspective this is far from enough, especially, if the former is designed to preserve financial globalization.

The empirical evidence shows that financial globalization has increased macroeconomic volatility in developing countries with deleterious effects on economic and social development (Stiglitz, 2004a). Indeed, even the IMF has recently recognized that there was no empirical evidence to support the hypothesis that financial globalization had positive effects on economic growth in developing countries (Kose, Prasad, Rogoff, and Wei, 2006). International capital flows are strongly procyclical, while dependence on

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<sup>4</sup> Most of the time, a proposed Americanization.

international financial markets increases external vulnerability, the Achilles' heel of developing countries. Furthermore, financial globalization facilitates capital flight. Thus, the residents of many highly indebted countries hold foreign assets of amounts comparable to their country foreign obligations. As a result, the degrees of freedom of policymakers are drastically reduced and the resources available for development are diminished.

Besides, the direction of capital flows in the current phase of financial globalization are mainly North-North and the bulk of is portfolio investments, unlike the first phase of globalization a century ago when capital flowed from North to South in the form of on-term capital investments. Obstfeld and Taylor (2002) conclude that the current wave of financial flows is more about international portfolio diversification unlike a century ago when international capital flows provided finance for development.

Furthermore, as pointed out by Obstfeld (1998) and Rodrik (1997), globalization favors the more mobile factors, mainly, capital. Therefore, capital taxation in a world of free capital flows becomes very difficult. This is worsened by tax competition among countries, leading to a race to the bottom. As a result, the scope for policies becomes narrower and the brunt of taxes falls over labor with negative distributive and competitive impacts.

Often, central bankers in developing countries are forced to keep a higher level of international reserves in case of short-term capital inflows in order to reduce the impact of sudden stops. Thus, the potential benefit of short-term inflows in terms of additional financing for a cash-hungry country is mostly neutered, although the country still has to pay a net high interest rate for these capital inflows (Stiglitz, 2004a).

One of the worst consequences of financial globalization is the debt overhang of overborrowing processes carried out very under authoritarian and corrupt governments which enjoyed the political support of the rich countries. Here, international financial market failures interacted with domestic political failures and yielded the worst. The result is that highly indebted countries transfer a huge amount of resources to developed countries reversing the old conventional wisdom according to which a developing country should get a net transfer of resources from the rich in order to achieve economic development. Argentina and Brazil, for instance, have budget primary surpluses of 3 and 4 percent of GDP, respectively, in order to meet their foreign debt service, diverting scarce resources which could be used to fight poverty build infrastructure, and provide better educational and health services.

It is true that most developing countries show more structural vulnerability than developed countries. Reliance of exports on few primary commodities is a main explanation. Poor infrastructure and inequality are often serious problems too. In this regard, it is right to say that financial crises have domestic roots and that developed countries are more resilient. The point, however, is how to achieve resiliency, i.e. development. There are almost no experiences of countries which became developed after financial liberalization. Indeed, the East Asian success stories had in general significant levels of financial repression. Actually, most of them did not have a serious macroeconomic crisis in a long time before financial liberalization.

Many developing countries are prone to poverty traps. The point is that financial globalization raises the likelihood of poverty traps because the increased macroeconomic instability, capital flight and the erosion of the tax base which brings in, makes it much more difficult to mobilize the financial and fiscal resources necessary to carry on the structural transformations needed for development.

### Some proposals for discussion

The main question is whether we want to revamp and preserve financial globalization or we want to seize this opportunity to finish with the hegemony of finance, restructure the relationships between finance and the real economy and build what the French regulation school (Aglietta, Boyer, Lipietz) calls a new mode of development, one that prioritizes social inclusion and gives finance a secondary role. In other words, we should discuss how to re-embed finance into the real economy and the real economy in society at large.

Keynes's closing words in Chapter 12 of The General Theory are to the point:

"I expect to see the State, ..., taking an ever greater responsibility for directly organising investment; since it seems likely that the fluctuations in the market estimation of the marginal efficiency of different types of capital, ..., will be too great to be offset by any practicable changes in the rate of interest." p. 164

Therefore, the emphasis of the G-20 on prudential regulation, standards of accounting and disclosure, and risk management (Working Group 1) might end up being mere patchwork. Boyer (2008) recent call for some form of ex ante social control of financial innovations seems more to pertinent.

Regarding the issues taken by Working Group 2 "to enhance international co-operation in the regulation and oversight of international institutions and financial markets, strengthen the management and resolution of cross-border financial crises, protect the global financial system from illicit activities and non-co-operative jurisdictions, strengthen collaboration between international bodies, and monitor expansion of their membership", a termination of tax havens and banking secrecy is paramount.

The management and resolution of cross-border financial crises is very important and there is much to do in this regard. However, it is very important to do everything we can to prevent these crises. For instance, investments in securities denominated in currencies other than the issuing debtor's own, could be strongly discouraged. The 2001 Argentine crisis provides a good example of how the underestimation of exchange rate risks and related default risks can lead to overlending and overborrowing. This does not imply a ban on the investment in foreign securities when they are denominated in the currencies of the debtor's country.

But prevention would require other measures. Rich countries and the IMF should give up pressure for capital account convertibility and allow for different kinds of capital controls. However, as developing countries have limited power over short-term capital flows, the first-best measure would be an internationally coordinated Tobin tax on international financial transactions to discourage speculative capital flows (Eichengreen, Tobin and Wyplosz, 1995). The proceeds of the tax could be used to fund a variety of development programs or global public goods (Stiglitz, 2004b). If now is not the time

for the Tobin tax, when? A Tobin tax would strengthen the national autonomy of developing countries' policymaking and will discourage cross-border speculation.

Since capita flight has played a major role in cross-border financial crises, an important measure to discourage the latter is the implementation of a global taxation base on foreign assets. To be effective, this would require the elimination of tax havens, also a fundamental measure to fight terrorism, corruption, traffic in drugs and other illegal activities. This action in itself could have a much larger impact than debt write-offs or increased lending.

It is also important to develop a multilateral framework for the restructuring of sovereign debt. As creditor institutions, the IMF or the World Bank should not play a leading role in this framework. Chapter 9 is a better base than Chapter 11 for the former. The Economic and Social Council of the UN is better suited to play a leading role.

Besides, a consultation with the International Court based at The Hague, on the issue of the legitimacy of foreign debts contracted by military dictatorships should be asked by the General Assembly of the UN. This is an application of the "odious debts" doctrine currently pursued by the US on the Iraqi case, but the problem is older and more general. These debts are a heavy burden, which loom in many young democracies across the developing world.

Concerning the governance of the IMF (Working Group 3), it is clear that we should end with its plutocratic and oligarchic structure. Developing countries will be hard hit by the current global recession. The IMF could play a positive to handle the crisis but this requires more than a badly needed increase in resources: it demands the reform of conditionality. We still see the IMF applying a double standard to rich and poor countries, advising expansionary policies in the former and contractionary policies in the latter. As to resources, Robert Mundell (2009) has recently proposed in Havana a one trillion dollar unconditional allocation of SDR for developing countries in order to prime the pump of recovery.

The allocation of SDR would also be an important step to eliminate the real cost imposed on developing countries by the current international monetary system based on the seigniorage of the US. Growing economies demand higher international reserves. These are either borrowed or set aside from the current account surplus. Both have a real resource cost. The birth of the Euro is no solution for non-Europeans. (Stiglitz, 2004b) made the same proposal to alleviate the aforementioned problem and also provide resources to fight poverty and foster development.

In the case of the MDBs, again their plutocratic and oligarchic structure should also be changed. It is essential to terminate policy reform lending in order to return to the financing of infrastructure investment.

Regional cooperation is another fertile ground to advance in some of these issues. The recent reappraisal of South-South integration provides a favorable environment. The Bank of the South in South America, is a promising project. While we wait for a multilateral Tobin tax, regional controls on short-term capital flows could be more effective than single countries attempts. They can also solve some prisoner's dilemma involved and facilitate macropolicy coordination (Carrera, 2004).

Regional cooperation could evolve towards regional monetary funds. McFadden (2004) and Wyplosz (1999) have argued that countries should have a choice on whether to prefer to be a member of the IMF or some regional monetary fund, introducing thus some institutional competition.

Finally, while working in the G-20 we should not forget the G-24, which represents developing countries and has a long experience and expertise on the former issues. Instead, we should carry the voice of the G-24 to the G-20.

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