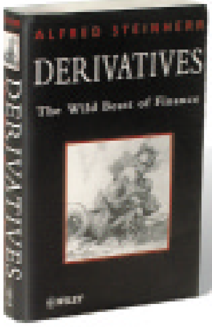


Alfred Steinherr

Derivatives

The Wild Beast of Finance

Wiley, New York, 1998, xvii + 430 pp.,
$79.95 (cloth).

ALFRED STEINHERR'S book is a well-written, clear, and nontechnical treatment of derivatives markets. It grew out of a paper he co-authored with David Folkerts-Landau (the former head of the IMF's capital markets group), which won first prize in the 1994 AMEX Bank Review competition. The book focuses on the rapid growth of the derivatives markets (particularly the over-the-counter segment), episodes of financial distress caused by misuse of derivatives, the systemic risks that such episodes can raise, and the associated policy implications. Steinherr's book is timely, in view of the role of derivatives and off-balance-sheet activities in the mature markets turbulence experienced in September–October 1998 (described in Chapter III of the IMF's *World Economic Outlook and International Capital Markets Report: Interim Assessment*, December 1998) and the recent focus by policymakers on the activities of institutions that use such instruments. While derivatives markets are one of the more technical areas of finance, the boxes, glossary, and extensive footnotes and references make the book accessible to general readers.

The book, which has four major sections, begins with some historical perspective and background, including a discussion of the key functions of financial markets, the "Americanization" of finance (that is, increased reliance on liquidity and trading of credit), and a description of some well-known episodes of financial distress associated with derivatives (such as the collapse of Barings). It then describes derivatives markets in detail, including their use in risk management, their economic functions, and the different mechanisms for trading derivatives (over the counter versus exchange traded). The third section discusses policy issues, including systemic risks from derivatives and whether the current policy structure is adequate to manage such risks, and suggests some policy options to deal with gaps in the current policy structure. The final section makes some predictions about the future evolution of derivatives markets.

The centerpiece of the book is the third section, which covers public policy issues. Steinherr argues that the growth in derivatives activities and the concentration of such activities in a relatively small number of institutions have heightened systemic risk. In his view, traditional financial regulation—oriented toward institutions and balance sheets, rather than functions and risks—has not kept pace with these developments. In addition, alternative approaches (the "internal models" approach, which employs banks' own estimates of their risk profile to set capital, and the "precommitment approach," under which a bank faces a penalty if its capital falls below a target level) have their own shortcomings.

Steinherr offers an alternative approach, which would combine improvements to the financial infrastructure—in particular, the use of clearinghouses or organized exchanges to handle the risks that are now traded in over-the-counter contracts—and a new regulatory framework covering all financial institutions and focusing on functions rather than institutions. This new framework would also rely more heavily than the current one on private risk management and measures to encourage financial intermediaries to internalize risks.

Steinherr makes a strong argument that his proposals would reduce systemic risk and limit moral hazard. Some readers may disagree, however, about the extent to which private risk management and measures to enhance the internalization of risks can substitute for the existing framework of official supervision and regulation. Even the best risk managers acknowledge that there are still important shortcomings in risk management; the current consensus is that internal risk models—particularly models of credit risk—need to be improved before they will be appropriate for regulatory applications.

Overall, the book is worthwhile reading for those interested in financial policy in general, and in the policy issues associated with derivatives in particular. Even readers who may disagree with some of Steinherr's policy recommendations will find his book thought provoking and useful.

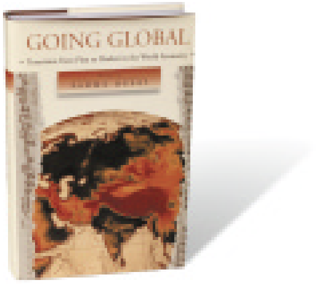
Charles Kramer

Padma Desai (editor)

Going Global

Transition from Plan to Market in the World Economy

MIT Press, Cambridge, Massachusetts,
1997, xiii + 507 pp., $63 (cloth).



GOING GLOBAL, the result of a project sponsored by the World Institute for Development Economics Research of United Nations University, focuses on the international implications of domestic changes during 1990–95 in 12 transition economies, Finland, and India. Finland is selected because of its close relations with the former centrally planned economies and India because of its shift away from heavy state intervention in the economy. The papers discuss market-oriented adjustment policies for trade and exchange rate regimes and assess the countries' progress in diversifying their trade structures and attracting foreign direct investment.

To provide background for the individual country papers, Desai, in her introduction, develops norms for assessing the comparative performance of the transition economies in opening up to the world economy. Using these indicators, she is able to address one of the critical questions of transition—whether speedier reform facilitates entry into the world economy. She finds that speedy reforms, along with the simultaneous implementation of comprehensive policy changes, appear to spur faster growth and disinflation while promoting the reforming country's integration into the world economy. But they also seem to have an adverse impact on employment in the short run. Thus, Desai believes that speedy reforms, once the trade-off is taken into consideration, are not necessarily superior to less ambitious, gradual reforms that impose few short-run difficulties and, hence, run a smaller risk of reversal. She concludes, however, that when this risk is judged to be unimportant, and the short-run costs are deemed to be socially acceptable, speedier reforms are desirable.

The section on Central and Eastern Europe covers the Czech Republic, Hungary, and Poland and also contains a particularly interesting review of east Germany's transition experience. Jürgen von Hagen, stressing the unique nature of this experience, explains not only that the former German Democratic Republic received large financial transfers but also that administrative and legal union, rapid privatization, and considerable technical support allowed a more rapid transition than in other countries. At the same time, the social safety net was more successful in east Germany than in other countries in protecting vulnerable groups from the most adverse consequences of the transition. Von Hagen takes the view, however, that the east German labor market was "drawn into the West German pattern of industrial relations, resulting in massive destruction of employment."

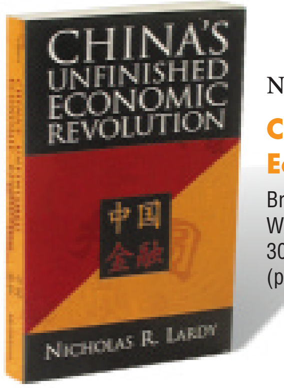
The section on northern Europe covers the Baltic states and has an interesting overview by Urpo Kivikari of the problems Finland faced because of the transition in other countries and the breakup of the Council for Mutual Economic Assistance trading bloc. He emphasizes, in particular, how Finland coped with the trading relationships spawned by the new economic structure in Central and Eastern Europe and Finland's position as a gateway between the former communist states and the West.

The third section covers Kazakhstan, Russia, and Uzbekistan. The study on Kazakhstan by Heiner Flassbeck, Lutz Hoffmann, and Ludger Lindlar focuses on macroeconomic stabilization, internal reforms, and the introduction of a liberal foreign trade regime, giving a lucid review of the early years of the transition. The authors identify what they see as some of the weaknesses of the 1994 stabilization effort and argue that more heterodox stabilization measures would have reduced the output loss caused by the use of restrictive financial policies to combat inertial inflation.

The section on Asia covers China, India, and Vietnam. Manmohan Agarwal describes India's development since independence, noting the high level of state involvement and the decision to concentrate investment in basic industries, which was seen as a successful early lesson of the former Soviet Union's experience. He then describes the sustained change in development policy that came about after the economic crisis of 1991, explaining that while India remained a relatively closed economy, important steps were taken to integrate India into the world economy.

The volume is a very readable and useful supplement to the annual transition reports prepared by the European Bank for Reconstruction and Development and other reviews of the early transition period.

Eric Clifton



Nicholas R. Lardy

China's Unfinished Economic Revolution

Brookings Institution,
Washington, DC, 1998, xi +
304 pp., $44.95 (cloth), $18.95
(paper).

CHINA'S remarkable economic performance since it began to implement market-oriented reforms in 1978 has sparked much interest. Many observers have pointed to China's gradualist strategy of economic reform as a model for other transition economies. Others have noted that China's unique initial conditions, including a largely agricultural economy, allowed it to pursue such a strategy—implying that other transition economies would not necessarily be able to replicate China's success with a similar path of reforms.

Nicholas Lardy notes that this debate misses the important point—that China's success has come at a real economic cost. He identifies three interrelated—and in his view unsustainable—economic trends that have emerged in China over the past two decades and argues that the country must address serious challenges to ensure continued strong growth over the longer term. First, state-owned enterprises have become heavily indebted to state-owned banks. Second, these banks have extended loans at a rapid pace to the state-owned enterprises—many of which are not commercially viable—and have seen the quality of their loan portfolios deteriorate steadily. Third, government revenue has fallen sharply in the post-reform period, to one-third its level relative to output in 1978. As a result, the government has had to saddle the state-owned enterprises with excessive social obligations, further weakening their financial position and that of their creditors.

While Lardy's book focuses on the banking and financial system to highlight the importance of the reform challenges that lie ahead for China, he devotes an entire chapter to the evolution of the state-owned enterprise sector in the post-reform period and the weaknesses that have emerged. He notes that enterprise losses in this sector have mounted steadily over the past twenty years, while fiscal subsidies to nonviable firms have declined. At the same time, state-owned enterprises have been excessively burdened with wage payments, employment, and social responsibilities, which—together with asset stripping (the illegal transfer of state assets to nonstate ownership) and reforms in accounting and the tax system—have caused their financial indicators to deteriorate. Lardy concludes that "the lack of fundamental change in ownership and in corporate governance" is the underlying cause of the declining financial performance of the state-owned enterprises.

The banks, which have lent the bulk of their funds to state-owned enterprises, have suffered a similar fate. To elucidate the relationship between the two, Lardy traces the development of the banking system in China, including the establishment and transformation of financial institutions and the growth and pattern of lending by the financial system. He then presents a detailed analysis of banks' financial strengths and the extent of their nonperforming loans. Given the paucity of available financial information on the banks, this is a creditable and valuable exercise.

In Lardy's view, the poor financial health of the state banks is due to their limited ability to assess projects on a commercial basis and to the legacy of two decades of lending on a noncommercial basis. He argues that, to complete its transition to a market economy and sustain economic growth, China must strengthen its banking system and place it on a sound commercial footing. In this connection, he suggests a series of measures, including bank recapitalization, increased competition, interest rate liberalization, enhanced prudential regulation and supervision, rationalization and reduction of bank taxation, and increased independence of the central bank. These must be accompanied by reforms of state-owned enterprises and public finances, among which Lardy includes a strengthened bankruptcy law to protect creditors and the mobilization of additional tax revenue to finance bank recapitalization and enterprise reform.

This book gives the reader a rich understanding of the interrelationships among enterprises, banks, and fiscal policy during China's gradual but impressive economic transformation. It also provides some useful and interesting digressions, such as an analysis of the role of state bank lending in redistributing financial resources across the provinces of China. Lardy's comprehensive analysis of the problems in the banking sector suggests that China will face daunting challenges in the future, although he attaches significance to recent steps taken by the senior leadership to address them. In comparison, his suggestions for modernizing the financial system, while complete, are not as thoroughly analyzed in terms of their optimal speed and sequence of implementation. But that, after all, is a part of China's story that has yet to unfold.

Aasim M. Husain

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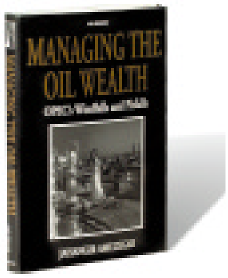

Jahangir Amuzegar

Managing the Oil Wealth

OPEC's Windfalls and Pitfalls
I.B. Tauris, London and New York, 1999,
xiii + 266 pages, £35/$65 (cloth).

IN THIS authoritative and thought-provoking book, Jahangir Amuzegar offers a carefully reasoned narrative, based on extensive research and meticulously compiled data, to tell the story of 13 petroleum-rich countries; their aspirations and economic plans; their strategy for catching up overnight with the West; and, finally, the embarrassment they suffered when they were unable to fulfill their ambitious plans to reduce their dependency on oil and to create a base for sustainable economic growth. This book is required reading for every student of political economy.

When so many countries can "burn away" so much wealth in so short a time, it is legitimate to ask if there is a curse on all individuals or countries that become rich too quickly. This question, which has puzzled scholars since the dramatic oil price rise of 1973–74 made possible the largest peacetime transfer of wealth in the history of the world, is the central theme of *Managing the Oil Wealth*. Amuzegar, onetime minister of finance of Iran (a founding member of the Organization of Petroleum Exporting Countries (OPEC)) and a former Executive Director of the IMF, has written extensively on international financial issues and the economies of Iran and other oil-exporting countries and is highly qualified to answer this question.

The book covers the 20 years from 1973–74 to 1994, examining the countries' economic strategies and the results they achieved and measuring their accomplishments against both the goals they had set for themselves and internationally accepted standards for measuring economic performance. The oil exporters had set out to establish a sustainable base for a viable post-oil economy, exchanging their natural wealth for physical and human capital in the form of, among other things, extensive infrastructure, modern irrigation systems and weapons, and a much better educated population with a higher life expectancy.

But their impressive accomplishments do not tell the full story. Many of the projects these countries undertook, as symbols of national prestige, were selected without proper cost-benefit analyses and suffered enormous cost overruns. In addition, the OPEC countries created large welfare systems, providing health and social services almost free of charge as a way of sharing the oil wealth. Worse still, their colossal expenditure plans depended on oil revenues increasing, which did not happen. In the end, instead of becoming the bankers to the world, these countries joined the debtor's club.

As sole owners of the oil wealth, the OPEC governments were largely responsible for the reversals of fortune in their countries. They introduced new politics of rising expectations, using fiscal policy to allocate new resources among their citizens; monetary and exchange rate policies became subordinate policy tools. Such a policy mix was a prescription for the Dutch disease (when a country's discovery of natural resources creates a prosperous new industry that causes the country's traditional industries to become uncompetititve internationally) that has infected all the OPEC countries at one time or another. An appreciating exchange rate combined with an overall strategy of promoting import-substituting industries led to the discouragement of exports other than oil, investment in projects in which the countries had no comparative advantage, severe price distortions, and a misallocation of resources. Over time, all these countries experienced fiscal and balance of payments deficits, high inflation, and high unemployment rates. Ironically, their per capita income was lower by 1994 than during the decade preceding the price rise of 1973–74.

Amuzegar describes and tests various structural and neoclassical theories to find an explanation for what went wrong. No one theory seems to explain the overall or relative economic performance of the countries, nor do the differences in their economic or political systems. Concluding that a country's success could be attributed to a combination of factors, the author identifies 10 such factors that, if present, can ensure a sustainable and satisfactory level of economic performance: a relatively small population or a low rate of population growth, a relatively high rate of investment in both physical and human capital, low government consumption, minimal wage-price distortions, early and adequate adjustment to the oil boom and bust, supporting cultural and entrepreneurial factors, a sufficiently large domestic market, availability of resources other than oil, relatively equitable income distribution, and an efficient government. A tall order indeed. The book concludes that none of the OPEC countries enjoyed the presence of all these factors in the right amounts.

Hassanali Mehran

Credits
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