1. INTRODUCTION

The integration of financial markets has taken place, and continues to take place, on two fronts.

- Internationally, markets have become more closely linked as capital has become more mobile. A transfer of funds between international markets is instantaneous, and no more complex than a transfer between domestic markets.

- Domestically, financial institutions are offering a wider variety of services due to reduced segmentation of the financial services industry. As a result, traditional divisions between different financial institutions have become blurred.

While financial markets have become more closely linked internationally, the relationships between capital flows, exchange rate movements and trade policy remain largely overlooked by standard international economic theory as well as those involved in the trade policy process. Trade theory provides little, if any, guidance as to how the gains from trade can be realized, or maintained, when firms are faced with international financial risks. Similarly, trade policy is inclined to neglect the potential financial uncertainty firms face when dealing in international markets.

With the expansion of world trade and the integration of financial markets, managing exchange rate risk has become an important corporate strategy. This Paper attempts to outline how the integration of the world's financial markets has had an impact on trade, primarily through exchange rate variability. It is not claimed that more integrated financial markets have led to more volatile exchange rates. Rather, it is recognized that the same factors that caused financial markets to become integrated have caused exchange rates to become somewhat more volatile.

The integration of the financial services industry is largely a domestic phenomenon. At the same time, however, financial services have become increasingly international, and have been part of several trade negotiations. This Paper does not investigate the role that negotiated reductions in barriers to the trade in financial services play in integrating capital markets. It is the author's opinion that trade negotiations on financial services, and their desired economic effects, are well understood, particularly by trade policy makers. This Paper instead focuses on how