While it is possible for derivatives to amplify certain episodes of volatility, they do not necessarily do so.[12] In fact, derivatives were developed initially in response to financial market volatility beginning with the increase in international capital flows in the late 1960s and continuing with the breakdown of the Bretton Woods system and the high and variable rates of inflation in the 1970s. The idea that derivatives can only add to volatility is incorrect. As outlined above, derivatives are widely used as instruments to manage risk. As such, they can reduce the tendency for overshooting if it is brought on by so-called "imitative trading" in which investors try to avoid potential future losses by selling assets when prices are falling and buying assets when prices are rising. Since one of the roles of derivatives is to reduce exposure to price variations, they can reduce the incidence of defensive imitative trading.

The Second Concern:
Financial Market Integration and Systemic Risk

Several studies have warned that the size and concentration of derivatives activities, combined with derivatives-related linkages between firms and across markets, could cause any financial disruption (either at a particular firm or in a particular market) to spread faster and be harder to contain.[13] Despite the fact that there has never been systemic financial instability due to derivatives difficulties in a particular firm or market, including the collapse of Barings Bank, it is still considered one of the most serious risks associated with the development of derivatives markets.

Capital Adequacy

For all financial institutions, capital is the cushion against losses that cannot be covered by current earnings. In 1988, representatives of bank supervisory bodies in twelve countries developed risk-based capital standards under the auspices of the Bank for International Settlements. Known as the Basle Accord, the agreement was meant not only to level the international playing field regarding banks' capital

[12] In fact, Kuprianov quotes a 1993 study by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance System and the Office of the Comptroller of the Currency which found that European foreign exchange market volatility in September 1992 would have been more pronounced had financial institutions not been able to manage their currency positions through the use of derivatives. See A. Kuprianov, "Over-the-Counter Interest Rate Derivatives", in *Economic Quarterly*, Vol. 79. No. 3, Federal Reserve Bank of Richmond, Richmond VA, Summer 1993, p 85.

[13] See, for example, General Accounting Office, *Financial Derivatives: Actions Needed to Protect the Financial System*, Washington DC, May 1994, p. 39.