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Financial Globalization: Some Conceptual Problems

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1. INTRODUCTION

In recent years financial liberalization, although not necessarily able to deliver a higher growth rate or for that matter to bring efficiency in the financial sector (Arestis and Demetriades, 1997), has brought a new twist in the process by introducing a highly politicized term, that of financial globalization. The term financial globalization refers to the process by which financial markets of various countries of the globe are integrated as one.

We wish to argue that although financial liberalization is a necessary condition for financial globalization, it is not a sufficient condition for it. The introduction of a worldwide single currency managed by a single international monetary authority is the sufficient condition. The first age of unregulated financial globalization that spans over the period from the 1870s to 1913, (when London arguably acted as the center of financial activity), was marred by a series of banking crises, a period which can also be categorized as the early stage of the development of international financial institutions and markets (Eichengreen and Bordo, 2002). The crises principally arose from speculation, excessive lending, poorly managed funds, ill-regulated banking systems and non-disclosure of information. The history of international financial sector development in the inter-war period, 1919 to 1939, was not a particularly happy one either; in fact it was deeply scarred by the stock market collapse in the late 1920s, followed by the Great Depression. The post World-War II period was characterized by a number of financial controls and fixed exchange rates. Banking crises were absent during the period from 1945 to the early 1970s, although currency crises were in evidence. From then onwards the process of financial liberalization began, and banking crises re-emerged in a new era of broadly flexible exchange rates, which brought about an era of free movement of capital. In this paper we seek to define the current epoch of financial globalization, and examine more closely the conditions that are required for its emergence.

2. FINANCIAL DEREGULATION

The detrimental aspects of free flow of financial capital following the experience of the Great Depression was recognized by many countries across the World. Accordingly, not only developed but also newly-formed countries undertook various measures in order to prevent financial instability. It was recognized that to prevent the latter, there was a need to control financial flows that were purely speculative in nature, and to ensure that possible expansion of aggregate expenditure in the productive aspect of the economy was not constrained by inadequate financial flows. Consequently, regulations within national boundaries took the form of preventing financial flows that were mainly geared for speculative activity. The specificity of the regulations may have differed from country to country, but the aim of those regulations was to ensure that credit would be allocated to industry and trade (Sayers, 1960; Basu, 2002).

In addition to those regulations almost every country made further provisions to ensure that the productive sectors were neither constrained by the price of finance nor by inadequate financial flows. These often arose either as a result of lenders' incomplete knowledge about a particular sector, or as a result of borrowers' inability to meet lenders' credit standards.[1] As a result, the ceiling on interest rates was introduced in order to ensure that borrowers were not constrained by the price, and specialized banks were developed to ensure that the lenders' lack of knowledge did not prevent the financial flows to specific sectors. Furthermore, in certain countries the government stood as guarantor, and in other countries banks were instructed to reduce the credit standard requirements. That was aimed at ensuring that certain groups of borrowers were not constrained by interruptions to the financial flows that arose from their inability to meet banks' credit standard requirements.

On the international side, a variety of controls were established in order to ensure that foreign financial flows were mainly concentrated on the productive side of the economy. In order to prevent free financial flow and exit, those controls also

embraced the purchase of foreign currency. In some instances, governments stood as a direct guarantor between the foreign lenders and the domestic borrowers. The reason was to ensure that the growth of local industries was not constrained by inadequate foreign financial flows arising from their inability to meet the foreign lenders' credit standard requirements.

The main objective of those regulations was to bring financial stability and to promote governments' economic and social objectives. This was the case for developed as well as for developing countries. An important implication of those regulations was to undermine the independence of the financial sector as a profit-seeking economic unit. A further implication was that, since banks were prohibited by regulation from advancing loans to certain areas of economic activity, there was the opportunity for new institutions to emerge in order to capture that end of the loan market. Banks' share of the loan market fell as a result, thereby affecting the effectiveness of the traditional tools of monetary control (Basu, 2002). This was mainly because these new institutions were not subject to the same regulations as the banks. Policies that were implemented in order to promote the access of smaller borrowers to the loan market at a cheaper rate, largely remained ineffective and adversely affected whatever limited access they may have had to this loan market in the past.

Serious doubts were also raised about the merits of administrative controls over interest rates, typically in developing countries, as a vehicle for a higher volume of savings at low interest rates, thereby inaugurating the well-known 'financial repression' thesis (McKinnon, 1973, Shaw, 1973). The view was taken that government intervention itself distorts the determination of the price of loans, thereby adversely affecting not only the allocation of loans but also savings. This led to the 'financial liberalization' thesis, initiated in McKinnon (1973) and Shaw (1973) and further developed by Fry (1995, 1997), King and Levine (1993a and 1993b) and others.[2] It was argued that in the absence of intervention, market forces would determine the interest rate, which in turn would govern the allocation of loans. The presumption was that interest rate plays a crucial linking and causal role amongst savings, investment and growth. Government intervention either distorts or de-emphasizes the role of interest rates, which produces lower savings and thus lower growth rates than otherwise.

3. CONDITIONS FOR FINANCIAL GLOBALIZATION

The crucial message of the financial liberalization thesis is that it is the lack of competition, which brings inefficiency to this sector. Interest rate liberalization is a first step, but it is recognized that this alone is not likely to generate competition in this market, in view of its oligopolistic nature. Consequently, not only is there a need to increase the number of players in this market, but also to tap a larger pool of savings for which a country may be required to go beyond their own domestic boundary. To increase the number of players there is a need to remove entry restrictions so that Non-Bank Financial Intermediaries (NBFI), as well as overseas banks can enter into this market. In order to tap a larger pool of savings, there is a need to not only remove controls over the purchase and sale of foreign currency, but also to relax laws relating to takeover and merger activities. This implies that there is a need to liberalize the external sector of the financial system.

A view emerged similar to that of the school of financial liberalization. Government intervention in the determination of the price of the currency causes a distortion in the allocation of exports and imports, thereby bringing an imbalance between them (Friedman, 1953; Krueger, 1974; Cordon, 1981). This problem might be further aggravated by the undue restriction on foreign direct investment, which may cause debt to rise to an unnecessarily high level which otherwise could be addressed via foreign direct investment. It was argued that if the currency was allowed to float then the mechanism of its appreciation and depreciation would ultimately bring a balance between exports and imports.[3] The remaining trade imbalance could be addressed by attracting foreign direct investment.

Accordingly, country after country started to float its currency, financial controls were removed and laws relating to takeover and merger activities were relaxed in anticipation that the threat of a takeover may improve the performance of those not performing as expected. In other words and as argued above, the external sector of the financial system also had to be liberalized. Internal and external liberalization of the financial sector was thus undertaken under the presumption that this in turn would bring efficiency to this sector, and would improve the growth performance of the countries concerned. In the process it opened up the opportunity for financial capital to move freely from one country to another. The speed of this movement in recent years has been further enhanced by the advancement in information technology. The combination of these two developments in recent years has given rise to the view that financial markets are now perhaps truly globalised. This belief might have originated from the assumption that the interest rate alone governs the allocation of loanable funds.

Consequently, it is the flexibility of interest rate movements that would bring the lending and borrowing countries into one market, thereby integrating all the financial markets across the globe. Hence, the word globalization was introduced which technically means the integration of the whole world into one; that different parts of the globe should be merged into one. But what was not recognized was that the loan market operates under conditions of uncertainty, and as a result interest rate variation alone cannot clear this market. This means that interest rates by themselves cannot bring lending and borrowing countries into one market. Lenders will ask for collateral or some form of security as an alternative means to recoup the loan, should the borrowers' projects fail. This alternative way of recouping the loan, is what we have already referred to as the credit standard (Basu, 2002). Therefore any nation wishing to borrow from the international financial markets would have to meet the credit standard requirements which are appropriate for these markets.

This problem is further complicated by the existence of different currencies with their different degrees of acceptability in the

international financial markets which implies that loans have to be paid in currencies that are acceptable to both parties. Countries other than those whose currencies are internationally recognized, would have to pay their loans in some foreign currency. The problem here is a critical one for those countries whose currencies are not recognized in the international markets. As these countries are required to repay their loans in a foreign currency, they have to offer assets as collateral, and these should be traded in international markets. This is required in that should they default on loans, these assets can be sold in the international markets to recoup the loan in foreign currency. This segregates the domestic financial markets from the international financial markets for these countries' borrowers. The borrowers who wish to raise funds domestically would normally be required to offer collateral against which they can raise loans. If these borrowers wish to raise funds from the international market then they will be required to offer as collateral assets that are acceptable in international markets. As opposed to this, countries whose currencies are recognized internationally are not required to repay the foreign loans in foreign currencies. As a result no distinction is required between their domestic assets and international assets; they can borrow from the international markets by offering either of these assets.

This distinction in the credit standard requirements between the domestic and international markets in some cases, but not in other cases, suggests that not only are we far from integration, but at best this market can be described as 'fractured'.[4] Consequently, in some cases large sections of the financial markets are able to integrate with the international financial markets, while in other cases only a small fraction is able to integrate. Furthermore, this difference between the credit standard requirements not only causes differential access to the international financial markets for different countries, but it may have far reaching consequences for the world economy.

The majority of countries whose currencies are either not recognized or have a low degree of recognition in international financial markets, would have very limited access to international financial markets, essentially because of their very small export sector and since they can only accumulate internationally recognized means of payment. Thus, countries with low export potential will have lower access to international financial markets than otherwise; as a result their growth rates may be retarded. Although the access of countries, with high export potential, to international financial markets would increase, the assets of their export sector would also enter as collateral. As the value of these assets are also related to export earnings, it follows that a fall in export earnings would not only cause a problem in maintaining the repayment rate, but would also cause a problem in recouping the loans from selling these assets. This is because a fall in the export earnings will adversely affect the value of these assets. The problem is that this collateral does not constitute alternative means of payment, because its value is directly related to the performance of the export sector. Such form of collateral arrangements at best can be described as an alternative expression for equity finance and loses the attributes that are necessary to fulfil the task of credit standard (see, also, p. 5 above). In other words, these loans carry a high level of credit risk, thereby introducing the seeds for financial crises.

It follows that although the current free movement of financial capital may have opened up the possibility for the emergence of integrated financial markets, it has also introduced the seeds for inequality in the world economy, and has increased the occurrence of financial crises. To avoid such conflict it is necessary to introduce a single currency that would allow international financial markets to adopt a uniform credit standard for all countries. To introduce a single currency and to implement uniform credit standard requirements, there is a need to establish a world central bank for the global financial markets. As it stands now we are not only far away from integration, but also in the absence of a single currency and a world central bank this process may reverse, as it happened in the past.[5]

4. CONCLUSION

The analysis that has been conducted here suggests that unregulated opportunities for free financial flows between countries are by-products of financial liberalization. But this opportunity for free financial flows between countries does not alone constitute financial globalization. To complete the process of financial globalization there is a need to develop a global institution that can play the central coordinating role. Of equal importance, there is a further need to develop a single currency, which neither depends on gold nor on any national currency. It is the single currency that will allow the global financial market to develop uniform credit standard requirements. In the absence of the latter, this process will bring periodical financial crises and will further aggravate the unequal distribution of income and wealth, which directly contravenes the true meaning of the word globalization. In short, as it stands now, we are still a long way from true financial globalization.

NOTES

1. As this market operates in the presence of uncertainty, lenders ask for collateral or some form of security in order to ensure that should the borrowers default on loans there remain some alternative means to enable lenders to recoup their loan capital. This is referred to as the credit standard (Basu, 2002).
2. See also Greenwood and Jovanic (1990), Levine and Zervos (1996 and 1998), Rajan and Zingales (1998), Roubini and Sala-i-Martin (1992) and Saint-Paul (1992) in this line of work. See also Arestis and Demetriades (1997), Basu (1994 and 2002), Diaz-Alecjandro (1985), Morisset (1993) and Singh (1997) who argue that the financial liberalization thesis is neither empirically nor theoretically tenable.
3. This adjustment process is referred to as the J-curve effect, which suggests that it will adversely affect the current account deficit initially, but ultimately it will improve it (Cordon, 1981).
4. The word 'fractured' is borrowed from Harris (1998), who argues that the developments discussed in the text produced

'regionalism' rather than financial globalization.

5. Historically speaking, the only time the world ever came close to such a situation was during the late 19th century, when Britain ruled the world. Banking crises in the late 19th century brought about an end to what appeared to have been the beginnings of financial globalization. Since then an attempt was made in 1944 but it collapsed in 1973, with the abolition of the fixed exchange rate by the USA. This led to the emergence of regionalism, which is perhaps still in a transitional phase (Harris, 1998).

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