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Positive and negative effects of financial globalization on developing and emerging economies

Abstract

The topic of financial globalization has always been highly controversial. This controversy could be explained by the benefits and problems it generates. On the one hand, financial globalization creates tremendous potential benefits for developing countries and emerging markets, as they integrate financially with the rest of the world. Globalization stimulates the development of financial sector and, in turn, spurs the advancement of economies. On the other hand, financial globalization also carry some risks. One well-known risk is that globalization can be related to financial crises. The crises in Asia in 1997–98, Brazil in 1999, Turkey in 2001, are some examples that captured worldwide interest. This phenomenon was also seen during the recent global financial crisis. Since the financial crisis spilled over from the US and hit Europe, the effects of the crisis have become increasingly felt in developing and emerging countries as well.

From a historical perspective, financial globalization is not a new phenomenon, but the depth and breadth of globalization today are unprecedented. The recent wave of globalization has generated an intense debate among economists, attracting both strong supporters and opponents. This paper tries to present a balanced view of financial globalization,outlining the benefits and riskst that globalization entails for developing countries and emerging markets. The paper revisits the arguments and evidence that can be used in favor of and against globalization.

Key words: financial globalization, developing countries, emerging markets, financial crisis

1. The economic globalization concept analysis

The term “globalization” is widely used in various sources of literature. Many authors refer to it in different ways. It is a complex combination of economic, technological, sociocultural, political and other forces. Globalization is not a new phenomenon. It began in the late nineteenth century, but its spread slowed during the period from the start of the First World War until the third quarter of the twentieth century. The process of globalization accelerated during the eighties and is growing and developing ever since. This process has rapidly increase during the last 20–30 years under the framework of General Agreement on Tariffs and Trade and World Trade Organization, which made countries to gradually cut down trade barriers and open up their current accounts and capital accounts. This recent boom has been largely accounted by developed economies integrating with less developed economies, by means of foreign direct investment, the reduction of trade barriers, and in many cases cross border immigration[1].

Globalization is often used to refer to economic globalization, that is, integration of national economies into the international economy through transnational trade, foreign direct investment, capital flows, and migration. Economic globalization is a dynamic and multidimensional process of economic integration and whereby national resources become more and more internationally mobile while national economies become increasingly interdependent. This process refers to the reduction and removal of barriers between national borders, in order to facilitate the flow of goods, capital, services and labor.

Financial globalization as a part of economic globalization, is understood as the integration of a country’s local financial system with international financial markets and institutions. This integration typically requires that governments liberalize the domestic financial sector and the capital account.

The first decade of the century witnessed a rare rise and fall in capital markets, both international and domestic, in developed and developing countries alike. To be sure, it is not the first time international capital markets have experienced such booms and busts – two

[1] Sliburyte L. and Ostaseviciute R. (2009): “Theoretical aspects of economic globalization impacts on emerging economies”, Kaunas University of Technology, Lithuania.

remarkable episodes in the 20th century were lending boom decades preceding the Great Depression and the collapse of the Bretton Woods system in the mid-1970s. The recent episode started in the early 1990s and continued through 2007 with a few interruptions by financial crises that were mostly limited to developing countries[2].

2. Economic globalization in emerging markets and developing economies

The mein drivers for economic globalization in emerging economies are liberalization of capital movements and deregulation of financial services, the further opening of markets to trade and investment, spurring the growth of international competition .

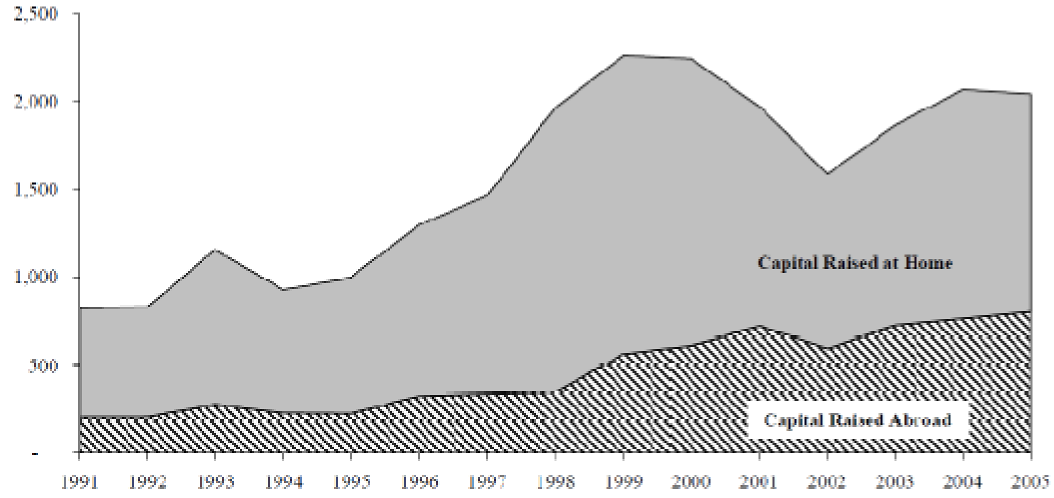
Capital flows to a large number of emerging economies expanded rapidly during the 1990s. Between 1991 and 2005, 28 percent of developing countries' equity and 47 percent of their debt securities were issued abroad. For the same period, 8 percent of developed countries' equity and 35 percent of their debt securities were issued abroad. Figure 1 shows the dynamics of domestic and foreign debt and equity capital raisings by private firms in developed and developing countries. This capital raising boom ended when financial crisis broke out in August 2007[3].

[2] Ocampo J.A. et al (2000): "Financial globalization and the emerging economies" United Nations and International Jacques Maritain Institute, Santiago, Chile.

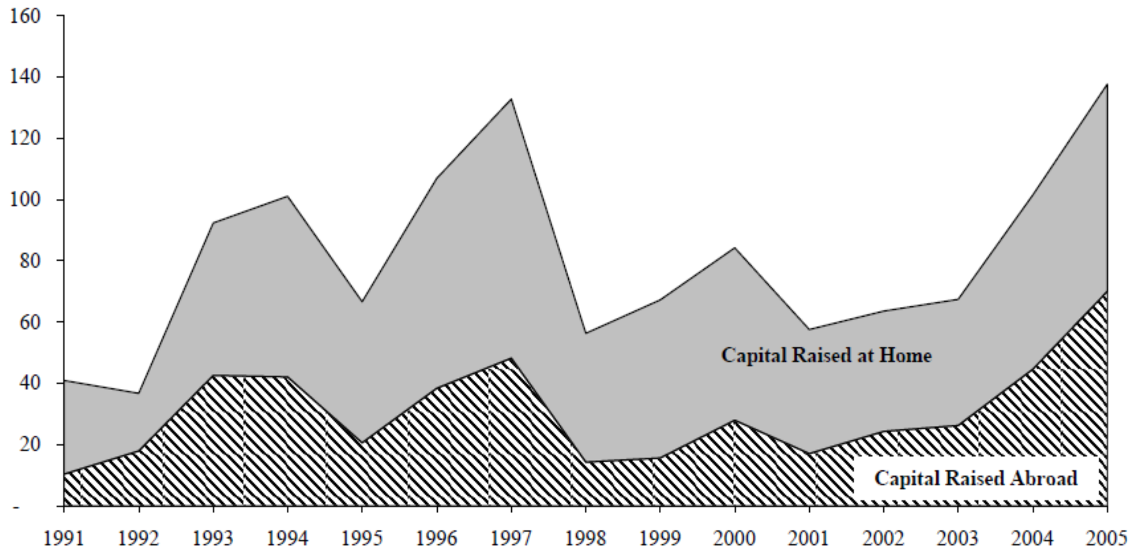
[3] Hale G. (2011): "Evidence on financial globalization and crisis: capital raisings" Federal Reserve Bank of San Francisco, Working Paper 2011-04 January.

Figure 1. Amount raised by firms through debt and equity markets

Developed countries



Developing countries



Source: Hale,2011

Emerging markets are those with young and undeveloped financial markets and relatively scarce domestic capital. The main reason foreign investors are interested in holding assets of firms in emerging markets is the historically high return on these assets.

Foreign capital raisings by emerging market firms are a relatively new phenomenon. Financial liberalization among the emerging markets, including the liberalization of cross-border capital flows, was led by Latin America after the debt crisis of the 1980s and by emerging Asia starting in the mid-1990s. After the collapse of the Soviet Union in the early 1990s, Eastern European markets and the countries that were formerly part of the Soviet Union also opened their borders to international capital flows.

3. Effects of economic globalization on emerging markets and developing economies

What is globalization? Does this mean that all countries of the world are becoming the same? Does it mean that individual countries will not be able to make business and trade decisions on their own but will have to consult other countries? If these are the realities of globalization, what kinds of impacts will it have on the way we live? Indeed, the concept of globalization raises many questions and controversial issues.

Some argue that globalization is a positive development as it will give rise to new industries and more jobs in developing countries. Others say globalization will force poorer countries of the world to do whatever the big developed countries tell them to do.

There are several significant effects of economic globalization. Economic globalization is the key factor in the emergence and development of emerging economies. Economic globalization has had exclusive impact on emerging economies' labor force. The flow of the investment first comes to regions to exploit cheap labor force, but with time, this impact becomes a positive one, as the wages gradually rise. This process also has helped to decrease poverty in emerging markets and developing economies.

One of the main benefits of financial globalization is the development of the financial sector. Financial markets become deeper and more sophisticated when they integrate with world markets, increasing the financial alternatives for borrowers and investors. Financial markets operating in a global environment enable international risk diversification.

The abolition of capital controls in the rich countries means that citizens and corporations of the rich countries can now invest in emerging markets' economies. Even more importantly, trade liberalization means that emerging market countries' advantages in the factors of production (abundant land and labor principally) can be exploited[4].

Financial globalization could, in principle, help to raise the growth rate in developing countries through a number of channels. Some of these directly affect the determinants of economic growth (augmentation of domestic savings, reduction in the cost of capital, transfer of technology from advanced to developing countries, and development of domestic financial sectors). Indirect channels, which in some cases could be even more important than the direct ones, include increased production specialization owing to better risk management, and improvements in both macroeconomic policies and institutions induced by the competitive pressures or the "discipline effect" of globalization. Financial liberalization tends to develop the financial system, enhancing the financing opportunities, reducing the cost of capital, and increasing investment and liquidity.

Financial globalization, in combination with good macroeconomic policies and good domestic governance, appears to be conducive to growth. For example, countries with good human capital and governance tend to do better at attracting foreign direct investment (FDI), which is especially conducive to growth.

The influx of international corporations not only brings positive advantages regarding global financial transactions. Some may emphasize that the multinational corporations may raise education levels as well as the financial health in developing countries, but that only applies to the long term effects of economic globalization. In the short term, poor countries will become poorer and unemployment rates may soar. Automation in the manufacturing and agricultural sectors always follows the appearance of multinational corporations. This lessens the need for unskilled and uneducated workers,thus raising unemployment levels.

Financial globalization can also carry some financial risks. These risks are more likely to appear in the short run, when countries open up. One well-known risk is that globalization can be related to financial crises. The crises in Asia and Russia in 1997–98, Brazil in1999, Ecuador

[4] Kraay A. and Dollar D. (2001): "Trade, growth, and poverty" Policy Research Working Papers, World Bank, June.

in 2000, Turkey in 2001, Argentina in 2001, and Uruguay in 2002 are some examples that captured worldwide interest[5]

Advances in communication, information, transportation and trading technology have helped web together nations into interconnected and interdependent communities. But this interconnectedness helps make the global economy more susceptible to economic shocks and crises Because of the world's interconnectedness, what might have in the past been considered to be a local problem can quickly become a global problem. The subprime mortgage crisis, the resulting banking crisis in the U.S., and the Greek Debt Crisis are often used by experts as the quintessential examples of economic contagion.

The recent stream of financial crises and contagion after countries liberalized their financial systems and became integrated with world financial markets might lead some to suggest that globalization generates financial volatility and crises. The health of one nation's financial system is now very much dependent on the health of other nation's banking systems and vice versa[6]

There are various links between globalization and crises. If the right financial infrastructure is not in place or is not put in place during integration, liberalization followed by capital inflows can deteriorate the health of the local financial system. If market fundamentals deteriorate, speculative attacks will occur with capital outflows from both domestic and foreign investors. If a country becomes dependent on foreign capital, sudden shifts in foreign capital flows can create financing difficulties and economic downturns.

Any potential increase in volatility tends to occur in the short run, right after liberalization. When countries first liberalize their financial sector, volatility and crises might arise, particularly in countries with vulnerable fundamentals. If the domestic financial sector is not prepared to cope with foreign flows and is not properly regulated and supervised, financial liberalization can lead to domestic crises.

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[5] Sliburyte L. and Ostaseviciute R. (2009): “Theoretical aspects of economic globalization impacts on emerging economies”, Kaunas University of Technology, Lithuania.

[6] Schmukler S.(2004):” Financial globalization: gain and pain for developing countries” Federal Reserve Bank of Atlanta economic review second quarter.

Financial globalization can also lead to financial crises through contagion, namely by shocks that are transmitted across countries. For example, when two countries trade among themselves or if they compete in the same external markets, a devaluation of the exchange rate in one country deteriorates theother country's competitive advantage[7].

Many developing countries need new industries and the jobs these industries bring to improve their economies through globalization, but they do not want to lose their own culture and identity in the process. Many developing countries fear that increased globalization may lead to loss of control over economic and political decisions and may also threaten their traditions, language, and culture. With the predominance of American pop culture as well as political and economic influence around the world, many developing countries see globalization as a form of "Americanization"

Conclusion

Economic globalization is the increasing economic interdependence of national economies across the world, through a rapid increase in cross-border movement of goods, service, technology, and capital flows. In the last decades, countries around the world have become more financially integrated, driven by the potential benefits of financial globalization.

The recent wave of globalization has generated an intense debate among economists, attracting both strong supporters and opponents. This paper addresses the question of whether the ongoing global fnancial crisis and the process of financial globalization in developing economies and emerging markets are related.

Although developed countries are the most active participants in the financial globalization process, developing countries have also started to participate.

The paper revisits the arguments and evidence that can be used in favor of and against globalization. There are many arguments for and against globalization.The final conclusions

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[7] Mendoza K. and Quadrini V. (2009):" Financial globalization, financial crises and contagion" National Bureau of Economic Research, Working paper 15432, Cambridge, October.

is that there are substantial advantages that financial globalization brings: development of financial sector, international risk sharing, expanded liquidity constraints. On the other hand, if financial liberalization is undertaken when a country is not fully ready for it or the processes in financial markets are mismanaged, adverse outcomes occur: excessive risk taking by banks, debt accumulation by governments, financial and currency crises. Because of a high degree of financial cross-linkages contagion effects also emerge .

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