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Chapter

Rethinking Financial Globalization

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Abstract

This chapter introduces the concept of financial globalization and examines the factors driving financial globalization in emerging and developing market economies. The role of financial globalization in driving development and strengthening of the financial sector, sustainable economic growth, and the nature of innovations are explored. On a broader scale, there is a need to understand the developments in global financial innovation and implications for developing and emerging markets. The chapter explores the challenges, and risks and benefits of financial globalization to emerging and developing markets and how they will shape future behavior and interactions by economic agents in these markets. Financial globalization can lead to different outcomes that include but not limited to domestic capital flight and potential effects on net capital flows, investment, and growth; capital inflows and higher investment and growth; or volatile capital flows and unstable domestic financial markets. The chapter discusses the measurement issues on financial openness. These all need to be explored in this context and considering the rise in innovations in the financial sector.

Keywords: financial globalization, regulation, developing and emerging markets, financial risk, financial globalization impact

1. Introduction

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> *"No generation has had the opportunity, as we now have, to build a global economy that leaves no-one behind. It is a wonderful opportunity, but also a profound responsibility." – Former U.S. President Bill Clinton*

> *"Our global economy is out of control and performing contrary to basic principles of market economics." – David Korten, Economist and Former Professor at the Harvard School of Business*

> *"The lack of monetary discipline has become a hallmark of unfettered globalization. Central banks have failed to provide a stable underpinning to world financial markets and to an increasingly asset-dependent global economy." – Stephen Roach, Former Chairman for Asia and Chief Economist for Morgan Stanley [1]*

Financial globalization encompasses the increase in global connections created through cross-border financial flows. It has been on the increase among developed

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nations in the last four decades. These movements have been on the rise between industrialized and developing countries. Economic growth rates have been high in those countries that experienced huge capital flows but in others adverse results have been experienced. There has been a rise in the effects of the financial crises due to the increase in financial flows and consequently, huge macroeconomic and social costs have been experienced. Debate has been on the rise to rethink on the outcomes of financial globalization in the context of developing countries. Countries with huge financial flows have experienced high growth though literature fails to agree on the nature of the relationship between financial globalization and growth. As an extension, it has been challenging for past studies to explain the link between consumption and growth as the former is deemed to be a better driver of welfare by working through the latter. Countries that can register stable growth in consumption levels experience stable growth.

It is noteworthy to say that financial globalization has a positive effect on growth. This receives support from the past studies [2–4], which found a positive linkage between growth, investment, and financial development. As developed countries receive capital, they are bound to improve on their profitability levels on capital invested and more so, capital accumulation increases. However, it is important to point out that countries need to avoid being heavily indebted as this may harm growth. Literature brings a distinction between investment-globalization and indebtedness-globalization. The former is experienced as developing countries receive more loans that increase the burden of repayments with high interest rates in foreign currency. The latter is experienced when capital moves around the world in search of good returns. Most developing countries are caught up in debt which is retrogressive. This has caused such countries to rethink of a possible way out. For example, import substitution industrialization has failed to pay dividends and it contrasts with export-oriented industrialization experienced by the countries in Asia [5]. This is also supported by Gaies et al. [6] who show that growth is improved by both financial and investment globalization, while indebtedness globalization causes financial instability that has adverse effects on growth.

Discussions of its impact on growth through trade are widespread. For example, Balcilar and Gungor [7] show that globalization has enhanced growth prospects of nations as it works through financial development. The immediate effect of globalization is to improve the financial services sector. There is a marked improvement in domestic financial flows as savings rise. It leaves policy makers with the need to draft and implement policies that improve access to funding and the usage thereof. Abraham and Schmukler [8] also show the importance of focusing on risk and not only the potential growth as failure to do leave the country exposed. There is still possibility that the economy is susceptible to global risks. This requires an effective support that comes from strong institutions within the economy. High-quality institutions are vital for effective and positive developments in the economy. The expectation is that as financial globalization increases, there are positive effects on the economy information of improved diversification and improved allocative efficiency of credit as entrance of foreign institutions deters government interventions in the economy [9]. The coming sections discuss the key concepts underlying financial globalization, brings clarity on the issues of definitions and measurement, sheds light on developments in financial globalization, its persistence and context in developing economies, its perceived impact, costs, and benefits.

2. The key concepts

Financial globalization and financial integration are taken to represent the same thing. In principle, the latter is experienced as countries are connected to international capital markets. In this context, financial globalization and financial integration are connected as a rise in the former leads to an increase in the latter. In most cases, the two terms are used interchangeably and hence, there is no need for confusion when that happens. More so, financial openness is the extent to which the financial market of a country is accessible by others and is synonymous with financial integration [10]. Financial globalization entails increasing capital account liberalization and having unhindered capital flows. This has been considered essential as a means for upgrading from lower- to middle-income status. It enhances stability of developed nations. On the other hand, it has been considered to bring global financial instability [11–13]. Financial globalization is a decision that policy makers should make seeing its importance. It requires policy makers to take care on how such decisions are made as hasting them may pose threats to their economic systems as they leave them exposed. What makes this debate interesting are the varying results, country experiences, and the speed with which they applied financial liberalization. Results have remained inconclusive as they are country specific, and they depend on the data and methodology employed leaving policy makers in different contexts with no direction. The aim is to focus on literature and bring out country experiences that could help developing and emerging market economies to rethink about this phenomenon and how they can adjust and use the same in their context.

The extent to which countries leave their markets open to financial flows determines the level and quality of capital inflows. Surprisingly, countries in Africa do not have strict policies hindering capital flows but they have experienced low financial flows. Pull and push factors help to understand these dynamics. The former arises from changes made to policies and other areas that seek to open markets like liberalization of capital accounts, privatization, and increasing flexibility in stock markets. The latter involves changes experienced in industrialized countries like changes in business cycles and other macroeconomic policies. The perceived increase in global financial risks has reshaped the behaviors in the financial system. The amount of global financial flows has fallen by more than 50% in absolute terms compared to their pre-global financial crisis levels. This fall has been explained by a slowed down in participation in foreign markets of financial institutions in the developed countries. Financial institutions in the Eurozone have made a retreat from foreign markets. There has been concern on the stability of financial institutions, their profitability, risk, and speed with which they respond to proposed regulations to strengthen their capital base [14].

However, there has been an increased presence in foreign markets by financial institutions from developing and developed countries such as China and Japan. China's prominence in global financial transactions can be traced back to the late 1970s when the financial and real sectors were liberalized. This opened the economy to foreign trade, which resulted in a rise in exports and growth of the manufacturing sectors. Inward FDI increased as firms got interested in the market to take advantage of the large population. FDI was critical in creating competition and advancing technology. Excess revenues from exports became a source of funds for building foreign currency reserves. The relaxation of restrictions on capital flows helped the Chinese economy to maintain a diversified role in global financial system. This was supported

by the government and central bank's decision to diversify their foreign holdings. The Chinese Renminbi is gaining momentum as widely a used currency in international transactions and it is now recognized by the International Monetary Fund as one of the currencies in its basket of special drawing rights. There is still need for the Renminbi to become a true international currency by becoming fully convertible at any time by market participants.

More so, unconventional monetary policies have been employed to support financial institutions in advanced economies. This shows the rise in risks and not necessarily an end of financial globalization. Such changes signal a move toward less risk financial positions. There has been a move toward correcting the causes of exposures in the pre-financial crisis period in which financial institutions held excess balances in their books. As much as financial globalization is becoming more inclusive, there is challenge of disruptions emanating from new financial technologies such as block chain and machine learning. They can ensure flexibility and increase in speed with which financial transactions are done across borders.

3. Measuring financial openness

Measuring financial openness has been a challenge. Basically, there are two ways of measuring financial openness. The traditional approach uses measures of legal restrictions on cross-border cash flows. These controls can be in form of those on inflows, outflows, on price, and quantity. An alternative approach is to measure the extent of a country's financial system's integration into the international capital markets. Quantitative measures have been generated to determine capital account openness and these have been changing depending on the authors and country information being applied. None of the generated measures is without shortcomings. It has been observed that most measures fail to explain the degree of financial openness with accuracy as they are generated using restrictions associated with foreign exchange transactions that may reduce the capital movements. They fail to gauge the extent at which capital controls are enforced as this tends to be dynamic. As explained, they fail to show the exact level of integration of a country into international markets. It can be possible that a country institute capital controls, but we can still see a surge in capital flows. It is also difficult to account for controls into the measures of financial openness as some may not be recognized as such by those who construct such indexes. Moreover, the measures of openness may be theoretical and not truly reflect the reality. Economists have attempted to measure openness using the price-based measures that look at common prices of similar financial instruments across the nations. However, these measures suffer setbacks when applied in developing countries as it has become difficult to quantify risk and other liquidity measures in these jurisdictions. It is possible to use measures like the investment saving correlations, but they also encounter problems of interpretation and how to apply them over long durations or periods. It has been argued that quantity-based measures are correct and reflect a true measure of capital account openness. An alternative measure of capital openness is to use either net or gross capital flows. This provides a measure that is less variable, which accounts for both types of capital flows reflecting countries' degree of accounting for and sharing risks efficiently. It is expressed as total gross inflows and outflows as percentage of gross domestic product (GDP). This is the standard measure of trade openness, which combines exports and imports.

Usually, this measure may provide measurement error, which is handled by using a measure of total of foreign assets and liabilities as a percentage of GDP. In the context of risk sharing, this measure including others of similar nature is considered as appropriate [15–17]. It is critical that emerging and developing markets think on the best measure of financial openness that explains the impact of financial globalization in their context.

4. Developments in the financial globalization

The changes in behavior of banks in developing countries are explained by an array of factors. As a result of heavy losses incurred during and after the crisis, financial institutions needed to rebalance their portfolios. The coming of Basel III meant that banks would need to raise capital through selling of existing assets to reduce the balance sheet size. The exiting of foreign markets by banks in developed countries was based on the realization that they earned lower margins in portfolios in those markets compared to earnings in domestic markets. This culminated in maintaining lean business lines, non-renewal of foreign loans at maturity time. The fear of exposure to high risk caused banks to hold less assets. More so, the coming in of new regulations in financial institutions in foreign markets meant that it became less attractive to maintain huge portfolios in those markets. Again, keeping large balance sheets would suggest increased size and complexity of managing such portfolios and hence huge commitment by financial institutions. However, banks in China, Japan, and Canada did not have much choice as they experienced a saturated home market. This meant the ideal option would be to expand activities in foreign markets. For example, banks in China have nearly 10% of their assets in foreign markets. However, this remains lower than the 20% foreign holdings of other developed countries.

In support of financial institutions post-crisis period, central banks have increased their balance sheets as a percent of GDP. For example, the combined total of balance sheets for central banks in Japan, England, Eurozone, and United States was more than 35% of GDP. The assets for the Central Bank of Japan are almost reaching 100% of GDP. The involvement of central banks in financial markets has become a necessity as they need to intervene to ensure enough liquidity and mitigate against chances of bankruptcy. There has been enhanced credit support in countries that have financial systems that are bank oriented. The central banks, in the Eurozone, had to fill in the gap created by the reduction in cross-border financial flows. The financial systems in United States and United Kingdom are predominantly capital oriented and as such central banks make targeted interventions in the money and capital markets. Withdrawal of the current support by central banks may result in bring unforeseen instability in financial markets. The current scenario of having less foreign holding, in foreign markets, by banks in the developed markets is a complete opposite of what happened during and after the Asian Financial Crisis in 1997/98. During that time, central held large assets bases in developing countries, which was underpinned by rising exports in commodities and manufacturing products. Central banks used the excess reserves from sale of these products to acquire safe and liquid assets abroad, which increased their holdings in treasury bills and other government bonds. Post the global financial crisis, receipts from sale of commodities and manufacturing exports to developing countries dwindled and as such central banks in developed countries have no excess funds.

5. The persistence of financial globalization

The retreat by foreign financial institutions may cause one to conclude that financial globalization has stagnated which is not true. There is still a strong link between the markets in the developing and developed countries. It is true that the rapid growth of the value of foreign investments as % of GDP has declined. However, the most integrated financial systems are still found in the developed countries that include the United States and those in the Eurozone. Developing countries and some emerging market economies are still lagging in the extent to which their domestic markets are deepened and ready to absorb and intermediate foreign capital flows. But China has been more aggressive in the growth in foreign investments and liabilities between 2005 and 2017. The country is currently a major investor in most developing countries compared to other developed nations. It appears the country is on a drive to make its currency to lead in global trade ahead of the United States dollar. According to Prasad [18], the dominance of China in global finance is expected to rise. On other fronts, we have noted the growth in holdings of foreign stocks and other investments in countries such as South Africa, Russia, and Mexico. Their collective holding in foreign markets now accounts of more than 14% of the global portfolio, which is double their holding in 2007. Their economies and role that they will play in global financial markets are expected to grow. Furthermore, we are witnessing the growth and establishment of international global hubs in countries such as Mauritius, Hong Kong, Ireland, and Luxembourg among others. Their global foreign investments have been on the rise since the 2007 crisis. These countries are supported by strong institutions and policies that include low tax rates, excellent regulations, and strong and vibrant banking systems. These hubs attract foreign capital and invest it abroad, which have implications on how we measure global financial flows and avoiding double counting.

More stability is expected in the global financial markets due to the increased regulation and strong capital bases driven by the Basel III accord. Monitoring has increased as banks are subject to stringent stress tests, and they are expected to hold a strong capital base and a certain amount of liquid assets. In addition, the share of flows in foreign direct investment (FDI) and equity in cross-border financial flows is increasing. Their level has reached more than 60% of cross-border flows which almost double their 2007 level. The rise in flows is expected to increase stability in international flows. Bank lending is short term and most volatile, while FDI is long term and regarded as stable. There has been a rise in remittances from migrants back to their families in the developing countries. These remittances are more than 60% of private capital flows, and it is more that thrice the level of official development assistance. We are still witnessing a fall in global financial imbalances, which are reflected by narrow deficits and surpluses. The financial and capital accounts for countries help to understand their net capital positions. For example, there are countries that have net outflows, which reflects that they are accumulating foreign assets and they are classified as suppliers of capital in the global financial system. There are countries in net capital inflows, which are, to larger extent, net borrowers and, hence accumulating foreign liabilities. Such deficits and surpluses have declined from 2.6% of GDP in 2007 to 1.7% of GDP in 2017. China stands out as one of the countries with a net capital inflow position with the likes of Germany and Japan. There is still high volatility in capital flows in form of cross-border lending in both developing and advanced economies. Such changes affect the exchange rates movements and cause adverse effects in the macroeconomy. This has implications on the required policies and strategies to cope with this increase in volatility. Systematic risk still exists due to poor

regulatory frameworks in the developing economics. This requires further action to develop policies on managing financial risks [19].

The risk of financial contagion still exists as financial markets are strongly interwoven and depend on each other. Contagion represents the spread of economic distress from one country to another. This is strengthened by the fact that countries have the same weaknesses as poor export demand or uncompetitive prices. Countries experience the flow of capital even with no changes in the underlying market conditions. The real and financial sectors interact with each other making it difficult to separate real from financial contagion. Financial contagion is seen in three dimensions. First, it shows the behaviors of investors who are trying to rebalance their portfolio whenever they experience a financial shock. Second, economies with weak institutions feel the adverse effects of investors' change in their portfolios. Third, the global economy is deeply integrated as such all economies are susceptible to the same shocks.

The advent of the Fourth Industrial Revolution has posed challenges and opportunities in the global financial system. For example, several applications have been developed, which affect the way financial institutions operate. Their monopoly in movements of money has been reduced as customers seek for online solutions. Online systems have proved to be cheaper, efficient, and convenient compared to traditional ways of moving finance. Thus, more global financial flows are expected to increase growth. There has been an increase in platforms that create new markets for financial flows. For example, lending platforms have been widened and other financial flows are being mediated by online platforms. Several digital platforms are being employed to raise and distribute funds that have created new ways of managing global finance. Blockchain is now on board to ensure quick, cheap, and safe global financial transactions and this is envisaged to cut transactions costs. Furthermore, other avenues have been created using artificial intelligence and smart machines, which increase efficiency. These platforms have potential impacts that can be felt on both domestic and international markets. In view of this, financial institutions need to look closely at the impact of these new online products on the way they operate. The implications thereof can guide on the development of new products or modernizing the traditional ways.

It is critical that financial institutions integrate ways of managing risk domestically and those applied internationally. As opportunities for international lending dwindle it is important for global banks to have an inward-looking strategy and make use of local liquidity. More so, overreliance on foreign operations is being hampered by increased regulations. In addition, foreign operations are becoming less profitable as international bank's market share fall. Banks are further deterred from foreign operations by increased strategic uncertainty. Performance has not improved despite efforts by financial market players to restructure their portfolios. This calls for new strategies to gain share in international markets. The financial reporting structure of banks must change as they find it more appropriate to combine balance sheets for local and foreign entities and not having to report their financials separately. Reporting separately has implications in the raising of funding by such standalone entities as they would need to show proof that they can sustain themselves. Banks will need to manage risks effectively and efficiently being supported by digital technology. Receiving high returns covering risks creates competitive advantages for such institutions. It may prove difficult for banks to cope with the demands to become digital players in international markets. More resources are required, and few banks have managed to secure digital transformation. Monitoring risks by financial

institutions requires more than just putting regulations, checking on systematic risk, and conducting stress tests. Basel III is still to be adopted and applied by several countries, which leaves banks, locally and internationally, exposed. There is need for making dynamic changes in the risk management architecture to cope with changes. This is driven by the continued volatile markets, which requires finding ways of coping with macroeconomic results of such fluctuations. As much as digital platforms can be useful in bringing efficiency in international financial transactions, they bring new risks such as money laundering and others related to terrorism. It is not clear how countries will respond not only to risk management but how they do monetary policy activities.

6. Developing and emerging market economies and globalization

Emerging markets account for a huge share of capital inflows to developing economies. For example, between 1980 and 1984 the share of gross stocks of foreign assets and liabilities has been 75% of GDP, while between 2000 and 2004 it stood at 59% for advanced economies. On the other hand, emerging market economies have accounted for 13% and 37% respectively in the same periods. This is explained by their level of financial integration into financial markets. Thus, there are notable differences across different country groupings on the types of capital flows. It is important to note the shift from debt to FDI and equity flows as forms of financing. Few developing countries participate in the process of financial globalization. Capital flows into developing economies are mainly in the form foreign direct investment (FDI) and equity. In emerging markets, such measures of capital flows (FDI and equity) are referred to as being less volatile compared to debt flows.

It is generally agreed that debt flows, including portfolio bond flows and commercial loans, come with more risk from financial openness. They result in inefficient allocation of capital, generate moral hazard, and fail to solve the problem of agency. Their high level of volatility means they can be easily reversed during time of crisis. Such reversals are experienced by countries that rely mainly on portfolio debt flows. Short-term debt is affected by business cycles as it rises with booms and falls with recessions. Thus, opening to debt flows increases a country's vulnerability to global shocks. Financial institutions tend to overborrow where there is weak supervision. Disaster comes with increased moral hazard and unrestricted capital movements. In the event of having an undeveloped financial sector, a country will suffer heavily from shocks after borrowing short-term debt denominated in foreign currency. The connection between short-term debt and financial crisis is evident. This is supported by the existence of currency and maturity mismatches of debt structures. This does not mean that a country would benefit by avoiding such debt flows. Rather countries can still borrow short and finance illiquid projects. The existence of illiquidity is the one that poses high risks and not borrowing short. However, by borrowing short a country commits to develop effective macroeconomic policies. For developing market economies, debt levels are raising, which pose threats to a new debt crisis. This could be averted by creating the right policies and attracting the right financing instruments [20].

There is concern on the effects of financial globalization on emerging markets. The role finance in brewing several crisis periods is generally agreed. For example, in the 1930s finance played a role in the economic depression, and developing countries have experienced debt problem early 1970s and 1980s. The role finance in

the currency crisis has been witnessed in several countries particularly in Asia and Latin America. There are imperfections in the emerging market economies that have increased the level of vulnerability to economic agents. Most countries have been adversely affected due to the contagion effect. More so, the main challenge in the global front is the asymmetry between markets that are sophisticated and dynamic and the non-availability of regulations. Countries have tried to develop tools for handling a crisis caused by such challenges, but evidence shows that they have fallen short. The economies have continued to show deflationary tendencies despite adjustment programs being put in place. Some economies have suffered a blow as investors tended to shy away from them due to loss of confidence [21, 22].

It is still critical that countries develop institutional frameworks for managing financial globalization. The development of an institutional framework for financial globalization will help to stabilize and remove market inefficiencies. This will provide international regulatory and supervisory system. The existing regulatory institutions need to be modernized to allow market players to make informed decisions. The economic systems that govern our decisions need to be flexible and keep abreast with changes in the developed market economies. It is important to say that institutions need to be proactive and give a framework that accommodates effective interaction at political, social, and economic level. All support institutions need to be consistent with the market operations as well as globalization. Pressure falls on existing systems to reform due to the increased systematic risk.

7. The impact of financial globalization

Financial globalization affects economic growth, volatility, and comovement. The contribution to growth is evidenced by the development of emerging market economies in recent years, particularly in countries such as India and China. But still, there is no agreement on the effects of financial globalization on growth as some studies argue that it has no effect while others argue that it drives growth. The different conclusions are a result of the different measures of financial openness applied [11, 15]. It is critical that the best proxy for financial openness be employed to examine its effects on growth. The types of inflows and outflows employed have a bearing on the outcomes obtained in growth. The effect of financial openness on growth has been limited in the developing countries [23], while it has been positive in advanced and emerging market economies [24]. Variations on the impact of financial openness on growth are explained by the period of analysis. Studies carried out over longer durations tend to be accurate in predicting the impact of financial globalization. The starting period also matters in explaining differences in findings [11, 24]. More so, differences in methodologies employed bring varying conclusions.

Though belief says so, there is no evidence suggesting that capital account liberalization causes financial crisis. Instead, financial globalization has improved the way in which risks are shared across countries. The crisis periods are a result of poor macroeconomic fundamentals. It is argued that capital controls cannot prevent a country from experiencing a crisis. But Edwards [23] indicates that higher capital mobility does not result in higher incidence of currency crises. Rather, it is found that capital account liberalization increases the incidence of banking crises, which tends to be more disruptive compared to currency crises. Hence, there is little evidence that financial crises are caused by financial globalization. There is no evidence linking financial globalization and volatility in output. As much as financial openness rises with volatility in consumption, it is better to keep markets open than to close the economy. As the degree

of financial openness increases, countries benefit from improved risk sharing and better consumption smoothing. This is mainly experienced by advanced economies compared to emerging and developing economies. The former has already passed this threshold, and this requires that the latter groups increase the level of openness to realize benefits of doing so. There has been an increase movement of business cycles and global factors. Correlations between output and consumption have been experienced in advanced economies because of financial openness. However, findings on comovement of output and consumption support those on the effects of financial openness on consumption and output volatility. Results need to be interrogated further using different datasets and ways of defining variables across and within countries. Lumping data across countries mean dealing with different capital flows that give misleading results and hence, a different approach may be needed. The benefits of financial globalization seem to be hidden in macroeconomic data but revealed in microeconomic data, which allows for more disaggregated analyses. At times it can be difficult to single out effects of financial openness from other variables. It should be noted that all measures and composition of capital flows are not the same. Flows such as FDI and equity are stable and do not easily experience reversals. More so, they bring indirect benefits such as managerial and technological expertise transfers. Thus, as we discuss the impact of financial globalization, there is need to consider changes of this variable over time in terms of measurement and composition. These data can be examined at both macro- and micro-level giving different results and statistical inferences.

8. Costs of financial globalization

Globalization results in sudden inflow and outflow of capital, which may bring instability to a country's development process. Capital account liberalization makes a country more vulnerable to sudden shifts in investor sentiments. There can be high costs of reversals of short-term flows of international capital. International flows of capital limit the national choices of effective monetary and fiscal policies. For example, it is not possible to, simultaneously, keep a fixed exchange, open the market, and follow monetary policy to attain desired aims. A country with a rigid exchange rate is vulnerable to crises when it opens its capital markets. Developing countries normally lack deep financial sectors and sudden changes in the direction of capital flows may cause boom bust cycles. Financial sector liberalizations need to be well managed; otherwise, they create crisis periods. It is also argued that trade integration must be put first ahead of capital account liberalization as it improves the cost benefit trade-off associated with financial integration. It reduces the probability of a crisis associated with financial openness and reduces such costs once they happen.

9. Benefits of financial globalization

As much as financial globalization comes with costs, we need to take note of the benefits. Foreign capital contributes to the development of the local economy and its flow helps to integrate international markets. The latter promotes improved allocative efficiency due to increased inter-temporal and inter-sectoral allocation of resources. It also removes limitations on a country's investment potential due to having inadequate savings. The benefits of opening capital flows are obtained on condition that such monies are used to expand the investment capacity of the country. Foreign

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capital removes liquidity constraints, allows inter-temporal reallocation of consumption and savings, improves the efficiency of local financial institutions, and causes policy makers to desist from following policies that create speculative tendencies that affect capital movements and interest rates. The quality of domestic macroeconomic policies influences the level and composition of capital inflows. Benefits of financial liberalization are quickly realized where there are sound fiscal and monetary policies. Institutional quality determines both outcomes and the actual level of financial integration. They influence the composition of inflows to a developing country and its capital structure may be moved toward FDI and receiving of equity flows. It is also agreed that capital mobility is on the rise and therefore cannot be stopped. The benefits outweigh the costs and capital flows will continue. For example, the advent of technology means small changes in interest rates would trigger movements of capital across countries within the shortest period. Countries are still prone to boom-bust episodes of huge capital flows to emerging markets. This could be followed by huge reversals and capital outflows. Badly managed booms create crisis periods thereafter.

Financial globalization comes with potential collateral benefits. There is greater widening of the domestic market, and it promotes efficiency gains for domestic firms as they get exposed to competition from foreign entrants. It acts as a catalyst for domestic financial market development as shown in the improved size of the banking sector and equity markets. Financial services are more likely to improve in a country with foreign banks than in a country without. Foreign entrants improve efficiency in equity markets. Stock markets tend to be more liquid and increase in size. Countries also adjust their corporate governance systems in response to increased globalization. Financial globalization influences growth through its indirect channels. Channels that are formed through building institutions, enhancing market discipline, and deepening the financial sector take time to be realized. This explains the reason why economists would quickly detect costs as benefits are realized over the long term.

It can be argued that countries meet with several complications as they adjust from less to more integrated financial market systems. Financial globalization comes with several benefits among them growth in the long-term and welfare gains. The failure of a country to provide support conditions leaves it exposed to shocks upon opening its capital account. Expected benefits tend to be delayed due to sudden stops in capital flows. The tension between benefits and costs of financial globalization always exists. The bone of contention is on whether to leave the country exposed to risks while expecting the collateral benefits to accrue. More so, it is important to check if a country must improve the domestic policies and quality of institutions while protecting itself from external forces. It is critical to note that risks cannot be avoided but they can be managed. Policies that work effectively in one country may not be of benefit to another. In other words, initial country conditions must be met before certain changes in the capital account can be entertained. A framework that generates benefits from opening a capital account while reducing risks is designed depending on a country's circumstances.

10. Exercises

- Describe the support infrastructure required by developing and emerging market economies before opening their capital accounts

- Outline the challenges and benefits of financial globalization in the context of emerging and developing economies

- Discuss how financial globalization poses risks and opportunities for driving growth
- Highlight the channels through which financial globalization affects developing economy
- Compare and contrast the different measures of financial openness.

11. Conclusions

This chapter has shown that financial globalization is not ending but rather it is changing the form. Benefits are both direct and indirect and they boost economic growth. The latter may turn out to be more important than the former in many ways. Increased growth comes with well-developed financial sectors, good quality of institutions, and good-quality macroeconomic policies. The magnitude and extent of the effect of financial globalization on the economy differs across jurisdictions and is explained by measurement issues, data quality, and methods applied in the analysis. When analyzing the effect of financial globalization, one needs to appreciate the channels, direct and indirect, that it works through. It is critical to understand the extent of a country's integration into the global space though this is not easy to do due to differences in measurement of key variables explaining financial openness. Measures that capture differences in legal and regulatory environment pose problems as such variables are operationalized differently across nations. There is still no concrete evidence that suggests that financial globalization causes financial crisis. More so, evidence on the composition of capital flows and their effect on growth are still inconclusive and require more research. Micro-data can better detect gains in productivity and growth emanating from financial openness compared to macro-data. Countries that meet desired thresholds levels on market development, quality of institutions, macroeconomic policies, and corporate governance do benefit more from financial globalization. It is critical that a country develop support infrastructure before opening its capital account to benefit from financial globalization. Identifying the types of reforms that a country should go through and correct timing are needed to generate the benefits of capital account opening, while mitigating against financial risk.

12. Implications

In view of the above, it is important that countries promote trade while putting in place effective tools for monitoring global developments that have spillover effects. This will help them to reduce contagion effect as well. Opening of trade and financial markets will improve efficiency in the domestic sectors of the economy. It is possible that as globalization increases, companies should improve production processes or rather develop new processes that help them to remain competitive. This will lower production costs and subsequently reduce prices on the global front. Subsequently, consumers will benefit as their welfare improves. On the other hand, countries need to develop effective tools for monitoring illicit financial flows that increase with globalization. Countering terrorism remains a priority and consumers will be adversely affected as currencies fluctuate and as job insecurity increases. This also calls for

governments, through the central banks, to come up with flexible but firm monetary policies that stabilize exchange systems and bring price stability. From a policy maker's point of view, it is critical to understand the channels through which financial globalization affects the economy. This helps in understanding its impact and the time it may take before such effects are felt. More so, this will help to design tailored policies that work effectively in each economy. Correct timing of policy implementation, improvements, and withdrawal is critical for the benefits of globalization to be realized.

Objectives

At the end of this topic, you should be able to:

- Define financial globalization
- Compare and contrast the different measures of financial globalization
- Discus the risks and opportunities brought by opening the capital account
- Examine the impact of financial globalization on growth
- Discuss the benefits and costs of financial liberalization

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