

The challenges of financial globalization

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Origins and evolution of the modern financial globalization

It seems useful to start from an historical perspective. The origins of the modern financial globalization process can be traced to the second half of the 1960s, when an incipient Eurodollar market was rapidly developing in London. Two events accelerated the process in the early 1970s. The first was the abandonment of the fixed exchange-rate regime that had applied since the Bretton Woods agreements. The change transferred currency risk to the private sector and stimulated the development of the currency and currency derivatives markets. The other early milestone was the oil price rise decided on by the Organization of Petroleum Exporting Countries (OPEC) in 1973. The first oil shock resulted in large trade imbalances, which had to be financed. The Eurodollar market experienced a sharp rise in demand, while the surpluses of the oil exporting countries supplied it with ample liquidity.

Financial globalization is a historical process with two dimensions. One is the growing volume of cross-border financial transactions; the other is the sequence of institutional and legal reforms implemented to liberalize and deregulate international capital movements and national financial systems. Quantitative growth and institutional and legal changes have been mutually reinforcing. Competition in capital markets has provided a major stimulus. As deregulated international intermediaries began to provide lower-cost services, this created pressure for cost reductions and fewer regulations at the national level. The new opportunities opening up in certain countries drove deregulation of transactions between countries.

International financial integration was initially mainly a developed-country affair. It is notable, however, that the largest economies in Latin America were part of the globalization process from the start. First Brazil in the late sixties, and then Mexico, Venezuela, Argentina and Chile were large recipients of capital in the 1970s. These last two countries, along with Uruguay, then pioneered drastic liberalizing reforms which anticipated those that were to be applied so widely in the 1990s. The participation of Latin America in financial globalization was interrupted by the debt crisis of the 1980s. This caused a hiatus of about eight years, during which voluntary financing dried up for Latin America and the process decelerated. Then in the 1990s the region re-entered the process vigorously, carrying out drastic reforms and becoming a recipient of growing flows (and ebbs) of capital. At the same time the financial globalization accelerated again and was extended geographically, mainly to the former socialist

countries and to East Asian countries. Developing countries participating in the process were called emerging markets and their financial assets have constituted since then a well defined class in the portfolios of specialized agents.

Financial globalization did not yield the results expected by its promoters

At the beginning of the 2000s, let us say in 2002, the insertion of the emerging market economies into the global financial system that had been evolving since the sixties seemed to have turned into a burden for economic growth and a source of instability. There was little room for optimism with respect to the prospects of those countries. Five main stylized facts supported this view.

First, financial and currency crises in emerging market economies were increasingly frequent and intense. Considering only the main episodes since the early nineties, the sequence encompassed the cases of Mexico and Argentina in 1995, the five East-Asian economies in 1997-98, Russia and Brazil in 1998-99, and Argentina, Uruguay and Turkey in 2001. Even the most favourable observers of the financial globalization process, like the Managing Directors of the IMF at that time, assumed the continuity of that trend and the emergence of new crises in emerging market economies, as an intrinsic characteristic of the global financial system.

Second, there was striking evidence on the volatility of capital flows and the propensity to international contagion. These characteristics were first observed with the repercussions of the Mexican crisis in 1995 and gained wide recognition with the strong global financial impacts of the Asian and Russian crises.

Third, the extreme cases of highly indebted countries, like Argentina and Brazil, weighed heavily in the diagnosis. At the end of the nineties both economies were locked in financial trap situations, with high country risk premiums, slow growth (e.g. Brazil) or recession (e.g. Argentina) and great external financial fragility. The Argentine crisis erupted in 2001 and was followed by the default of the external debt. Brazil had experienced the currency crisis in 1998-99 without defaulting on its external debt; however, even though the Brazilian exchange rate policy became more flexible after the episode, the economic policy and the economic performance was still locked in a financial trap at the beginning of the 2000s.

Fourth, most of the emerging market economies seemed to have entered into the global financial system in a segmented form. The phenomenon was evident in the

highly indebted countries. However, several emerging market countries that had managed their policies in order to avoid high debts and financial traps also experienced a segmented integration. After participating in the financial globalization process for a long time (almost three decades in the case of the Latin American economies), their financial assets constituted a “class” of assets whose yields included a considerable country risk premium. The country risk premiums had reached a minimum level in 1997, just before the devaluation in Thailand took place. But since then the country risk premiums have increased and they were still high at the beginning of the 2000s. Hence, given that the sum of the risk-free international rate and the country risk premium sets the floor for domestic interest rates, the financial integration seems to have condemned emerging market economies to systematically higher interest rates than those of the developed countries, with negative consequences on growth and income distribution.

Fifth, there was a reversal of the initiatives for international coordination that had followed the crises of the late nineties. At that time, some initiatives were taken in order to improve the so-called “international financial architecture”, to reduce volatility and contagion, to prevent crises and to improve the international management of the potential future crises. However, since 2001, the new Republican US administration and the novel authorities in the IMF have held the perspective that the very existence of multilateral support mechanisms set incentives for over-indebtedness and increased the probability of crises. At the same time, the IMF began to work on the Sovereign Debt Restructuring Mechanism, but this initiative, originally suggested by the new US administration, was abandoned some time after. Simultaneously, the interest in the “international financial architecture” also faded. By the early 2000s, the stability of the international financial linkages of emerging markets became more reliant on the spontaneous behaviour of the markets than ever before.

In sum, far from achieving the promise of greater stability and growth formulated by the promoters of financial liberalization and opening, the process of financial globalization seemed to have resulted for most emerging market economies in a new source of volatility and a burden for growth. In order to deal with the volatility that resulted from financial globalization, these countries had to implement their own preventive and defensive measures without the support (and in many cases even against the orientation) of multilateral financial institutions. As already mentioned, these circumstances did not leave much room for optimism.

By that time, I attempted to synthesize the difficulties confronted by emerging market economies as follows: “A country that intends to implement capital market and capital account regulations to avoid an unsustainable financial integration path has to confront with the IMF and the pressure of financial markets. It is a difficult task, but some countries have managed to do it. With regard to this issue, the target is well defined. We should put our efforts into promoting the appropriate changes in the rules and conditionality of the IMF and other multilateral institutions.

In contrast, without an important effort of international cooperation it seems difficult to find ways out of the highly indebted emerging market countries’ situation, and more generally, to establish an institutional context capable of neutralizing the segmented integration. The essence of the problem lies in that there is an inconsistency between the Nation States and an international financial system that lacks most of the institutions that have been developed over time at national systems to improve their stability and the way they work”.

The diagnosis was not wrong, given the evidence we had in 2002, but the pessimism was not justified *a posteriori*. Actually, in the following years the countries found unforeseen ways to avoid unsustainable paths and high debt financial traps without confronting with the IMF. On the other hand, the segmentation of emerging market assets almost vanished in the following years without any improvement in the international institutional setting.

The unforeseen novel trends

The novel trends have been associated with a remarkable change in emerging market economies’ financial integration and in the global system; in particular, the fact that developing countries started to become less dependent on foreign saving and that many of them actually became net suppliers of savings. This change started to become apparent in 2002 and more clearly from 2003 onwards.

The changes of the global financial system with respect to the previous trends are well represented by two facts. First, there were no new crises in emerging market economies, in spite of the emergence of various episodes of financial turmoil with contagion effects in the following years. Remarkably, the subprime crisis in the US did not trigger financial crisis in any emerging market country. Second, country risk premiums have followed a declining trend since early 2003 and from mid-2005 they fell

below the minimum value registered in the pre-Asian crises period. In early 2007 country risk premium reached their historical minimum, significantly lower than the minimum level of the pre-Asian crisis period and also significantly lower than the spread of US high-yield bonds. The country risk premiums rose after the subprime crisis, but even in the worst moments of the recent period the emerging markets' risk premiums were similar to the best moments of the pre-Asian crises period. Finally, it should be mentioned that simultaneously with these two developments in the global financial system, it has also been observed a substantial acceleration of developing countries growth rate.

These changes have been associated with novel features in developing economies in the 2000s, in comparison with the previous thirty years of financial globalization, both regarding the modalities of international financial insertion and the implemented macroeconomic policy regimes. The innovations began to take place after the 1997-98 Asian and Russian crises. The most striking novel features are as follows.

First, the generation of current account surpluses or the significant reduction of deficits in many leading developing countries (whose overall result was a reversal of the direction of net capital flows between developed and developing countries that characterized the thirty previous years). This new configuration of current account results persisted after the global crisis.

Second, the accumulation of large reserves in many developing economies. This feature also persisted after the global crisis.

Third, many economies adopted flexible exchange regimes (with varying degrees of administration by the monetary authorities).

In fact, there has been a significant reduction in the risk of financial instability in developing countries. Indeed, current account surpluses and foreign reserves are bulky external robustness indicators. In the 2000s the "class" of emerging markets assets became more heterogeneous and many of these assets correspond to robust economies. This helped to dispel the segmentation of emerging market assets and significantly reduce the risks of contagion and herd behavior with respect to this "class" of assets, so that reduction of risk was also extended to developing countries which continued showing current account deficits or did not make their exchange rate regimes more flexible.

The managed floating exchange rate regime allows the monetary authority to intervene in the foreign exchange market to prevent or mitigate the appreciation trends

and accumulate reserves, when the conditions of the current account and / or capital inflows lead to selling pressure in the market. This was the case in many emerging market countries after the Asian crises, particularly in the period 2002-2008.

The availability of reserves reduces the risk of default on public and private debts due to insufficient international liquidity under any exchange rate regime. But the combination of abundant reserves and managed floating tends to reduce the risk by other means. For instance, faced with a negative external shock, exchange rate flexibility leads to exchange rate depreciation, thus contributing to the economy's adjustment to changing external conditions. In such a case the availability of reserves allows the selling intervention to control and prevent overshooting and the formation of self-fulfilling bubbles in the exchange market. This limits the negative balance sheet effects on banks and firms, particularly in economies with partially dollarized financial systems. In this context, the exhibition of large reserves gives greater strength to the central bank's ability to guide the foreign exchange market and consequently large-scale selling interventions may be not required.

Lessons from financial crises

The period between the mid-seventies and early 2000s covers a range of crises that provide rich material for the analysis of the phenomenon. The analysis of the common features of the crises provides clear lessons on their causes. Consequently, the conclusions of the study of the set of cases suggest policies to prevent crises and to mitigate their effects and facilitate their resolution once they occur.

Overall, the crises in developing countries and the more recent crises in developed economies have highlighted the shortcomings of poorly regulated domestic financial systems. The general lesson is that reinforcing and extending financial regulation is essential to avoid instability and crisis. However, a specific conclusion from the study of developing countries is that the prevention of crisis in these economies involves elements that go beyond the regulation of the domestic financial systems. In developing economies, the conjunction of macroeconomic policy with the modality of insertion into the international financial system plays a crucial role in the financial performance. Consequently, crisis prevention in these countries also requires consistent macroeconomic configurations in which the exchange rate policy and the

policies related to the management of balance of payments and international reserves are crucial components.

In summary, the study of crises in developing countries suggests that in addition to strengthen and expand financial regulation, countries should: 1) adopt exchange rate regimes providing flexibility to policymakers and preventing speculation, 2) implement measures pointing to the regulation of capital flows and 3) implement policies that ensure the robustness of the external accounts, including the accumulation of international reserves and the preservation of competitive (or non-appreciated) real exchange rates.

The changes observed in many developing economies in the 2000s are consistent with the prevention measures suggested by the above lessons. So, it can be concluded that the robustness exhibited recently by developing economies can be seen as an a-posteriori confirmation of the recommendations derived from those lessons.

Conclusion

It is striking that the mentioned facts have little recognition by the multilateral financial institutions. Even without recognizing the role played by the new macroeconomic settings in the growth acceleration in developing economies, multilateral institutions can hardly ignore the positive effects that the innovations have had on the relations between developing countries and the international financial market. It should be accepted, at least, that the new context largely relieved the most negative traits that financial globalization showed at the end of the 1990s. But the official doctrine of the international financial institutions does not register those facts.

Neither has been systematized and discussed in our own countries the rich experience of developing countries with financial globalization. We are losing a valuable source of knowledge and policy lessons that should be essential part of the basis for the formation of policy-makers and for the further development of research on the subject.