BENEFITS AND RISKS OF GLOBALIZATION OF FINANCE IN DEVELOPING COUNTRIES: SOME EMPIRICAL EVIDENCE

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Abstract

This paper explores (he benefits and risks of" globalization of finance in developing countries. A number of empirical studies reviewed have tried to systematically examine whether, financial integration contributes to economic growth or not. Across different studies surveyed here, FDI is one form of capital inflows that tends to be found positively associated with domestic investment and domestic growth in a relatively consistent manner. Other forms of capital inflows could also have a positive relationship, but their effects lend lo be less robust or less strong. On (he risks of globalization of finance, some of the empirical studies reviewed found a number of problems associated with financial integration. For instance, many analysts revealed that the sudden collapse of the Southeast and East Asian economies in the late 1990s, was the product of a combination of external factors which globalization aims to integrate. The evidence on the benefits and risks of financial integration suggests that there is nothing inherently good or bad about capita! flows to developing countries. The paper recommends good governance and effective financial supervisory capacity, as on intermediate and more practical approach of containing the risks of globalization of finance.

Introduction

Globalization is the process which involves growing economic interdependence of countries worldwide. Many analysts are of the opinion that economic interdependence among the nations is not a new phenomenon, as popularly perceived. In fact, the present phase of Globalization is, in many ways, similar to the process of economic integration among nations, which began in the mid - 1800s and ended with World War I. During that period artificial barriers to economic exchange among countries were few; and as a result, the flow of goods and capital across borders as well as migratory flows of people were large (Singh, 1999). Of the three main economic aspects of Globalization usually discussed, namely, expansion in international trade, investment and finance, at least in the first two aspects Globalization then (approximately mid 1800s - 1913) is comparable "with what is going on now.

Globalization is nothing new. In many ways the world economy in the late 20 century resembles the world economy in the late 19[fl] century. The fundamental attribute of Globalization, then and now, is the increasing degree of openness in most countries. The openness is not simply confined to trade flows, investment flows and financial flows. It also extends to flows of services, technology, information, ideas and persons across national boundaries. There can be no doubt, however, that trade, investment and finance constitute the cutting edge of Globalization. The past two decades have witnessed an explosive growth in international finance. So much so, in terms of magnitudes, trade and investment are now dwarfed by finance (Nayyar, 1995). These have brought unprecedented growth and development to the developing world, reducing the number of poor people in developing economies by about 125 million between 1990 and 1999 (World Bank, 2001), Nevertheless, the benefits from globalization remain unevenly distributed. In developing countries with a combined population of about 2 billion (including most of the countries in Africa, the Middle East, and the former Soviet Union), growth declined in the 1990s, while poverty has been rising, and these countries risk becoming even more marginalized (AIonso-Gamo, Fedelino and Horvitz, 1997), In Nigeria for instance, the increased policy thrust towards economic liberalization and private sector dominance of the economy since the adoption of the Structural Adjustment Programme (SAP) in 1986 has resulted in a slight increase in the economic growth rate from an average of about 1.6 percent per annum in the 1980s to about 2.4 percent in the 1990s. This however, falls far short of the 6 to 7 percent annual growth rate required by most estimates if Nigeria (and several other African countries)

are to witness substantial increase in the living standards of their populace, majority of whom still live below poverty line (NEPAD, 2001).

Globalization of finance and financial integration are, in principle different concepts. Globalization

of finance is an aggregate concept that refers to rising global linkages through cross-border financial flows- Financial integration on the other hand refers to an individual country's linkages to international capital markets {Kose, Prasad, and Terrenes, 2003). Clearly, these concepts are closely related. For instance, increasing globalization of finance is perforce associated with rising financial integration on average. In this paper, the two terms are used interchangeably.

While globalization presents opportunities for nations to improve their economic performance, it also poses several risks and challenges. The main objective of this paper is to empirically, examine the benefits and risks associated with globalization of finance in developing countries, with a view to recommending a framework that will serve as a guide to them when they seek financial integration.

Accordingly, the paper is divided into four sections besides the introduction. The next section describes the trends in global financial flows. This is followed by the section which presents the methodology adopted in this study. Next is the section on the benefits and risks of globalization of finance in developing countries. Finally, the section on conclusion ends the paper.

Trends in Global Financial Flows

There has been explosive growth of financial flows, especially private financial flows to developing countries, during the 1990s. Advanced countries are the largest suppliers and also the largest recipients of foreign investment (both FDI and portfolio investment), in the global economy. For many years commercial bank lending accounted far nearly two-thirds of private capital flowing to developing countries (Adam, 2002). It has now been overtaken not only by FDI but also by portfolio investment.

A research conducted by the World Bank in 1997 provides details of the financial flows to developing countries, during the period 1990 - 1996 (as shown in Table 1).

Table 1: Financial Flows to Developing Countries in $ Billion

	1990	1992	1995	1996
Official Development Finance	56.3	55.4	53.0	40.8
Grants	29.2	31.6	32.6	31.3
Loans	27.1	23.9	20.4	9.5
Total Private Flows	44.4	90.6	184.2	243.8
Debt	16.6	35.9	56.6	88.6
Commercial Banks	3.0	12.5	26.5	34.2
Bonds	2.3	9.9	28.5	46.1
Others	11.3	13.5	1.7	8.3
Foreign Direct Investment	24,5	43.6	95.5	109.5
Portfolio Equity Flows	3.2	11.0	32.1	45.7
Total Flows	100.6	146.0	237.2	284.6

Source: Global Development Finance, World Bank (cited in Singh, 1999).

Methodology

The data used in this study were obtained from recent empirical studies on globalization of finance in developing countries. The basic data sampled comprises 55 developing countries- These were grouped into More Financially Integrated (22) and Less Financially Integrated (33) countries. The following countries were excluded from the analysis; those with population below 1 million, transition economies, some oil producers and those with incomplete or clearly unreliable data.

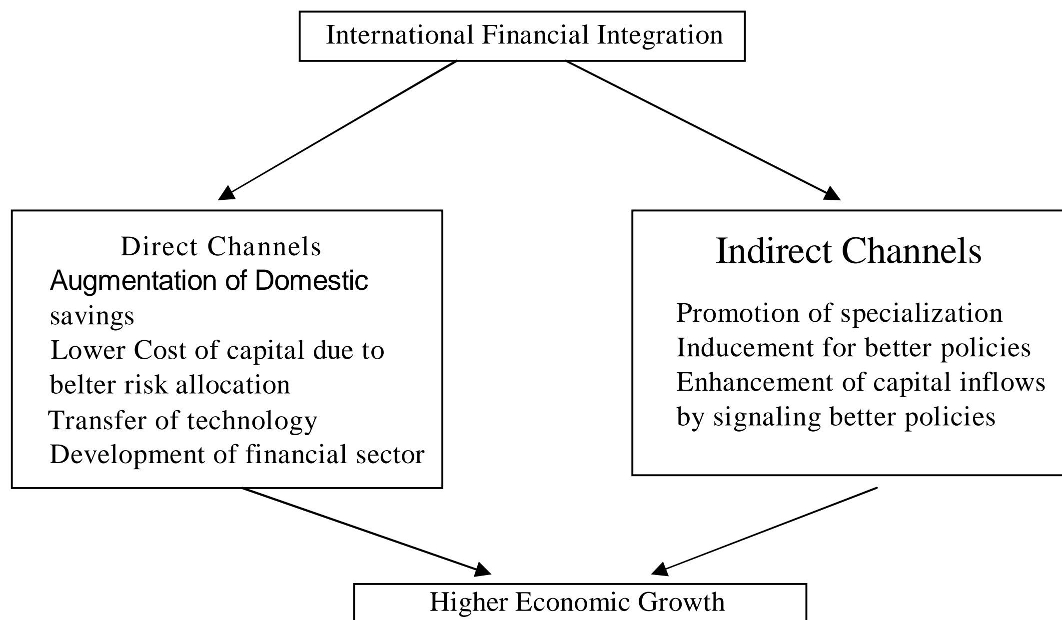
Benefits of Globalization of Finance to the Developing Countries

a. Potential Benefits of Globalization of Finance in Theory

In theory there are a number of direct and indirect channels through which embracing financial globalization can help enhance growth in developing countries. Figure I provides a schematic summary of these possible channels. These channels are interrelated in some ways, but this

delineation is useful for reviewing the empirical evidence on the quantitative importance of each channel. (Sec Borensztein, DeGregorio and Lee, 1988; Stulz, 1999; and Henry, 2000).

Figure 1: Channels Through Which Financial Integration Can Raise Economic Growth



Empirical Evidence

On the surface there seems to be a positive association between embracing financial globalization and the level of economic development. Industrial countries in general are more financially integrated with the global economy than developing countries. So embracing globalization is apparently part of being economically advanced. Within the developing world, it is also the case that more financial!} integrated (MFi) economies grew faster than less financially integrated (LFI) economies over the last two decades (as shown in Table 2).

Table 2: Fastest and Slowest Growing Economies During 1980-2000 and Their Status of Financial Openness

	Fastest Growing Economies, 1980-2000	Total Percentage Change in p.c. GDP	More Financially Integrated?	Slowest Growing Economies 1980-2000	Total Percentage Change in p.c. GDP	More Financially Integrated?
1	China	391.6	Yes/No	Haiti	-39.5	No
2	Korea	234,0	Yes	Niger	-37.8	No
J	Singapore	155.5	Yes	Nicaragua	-30.6	No
4	Thailand	151.1	Yes	Togo	-30.0	No
5	Mauritius	145.8	No	Cote d' Ivoire	-29.0	No
6	Botswana	135.4	No	Burundi	-20.2	No
7	Hong Kong SAR	114.5	Yes	Venezuela	-17.3	Yes/No
8	Malaysia	108.8	Yes	South Africa	-13.7	Yes
Q	India	103.2	Yes/No	Jordan	-10.9	Yes
10	Chile	100.9	Yes	Paraguay	-9.5	No
11	Indonesia	97.6	Yes	Ecuador	-7.9	No
12	Sri Lanka	90.8	No	Peru	-7.8	Yes

INote: Growth rate of real per capita GDP, is in constant local currency units. Source: World Bank's World Development Indicators (WDI) database.

Using data for the 1980s, De Mello(1999) reports evidence that FDI flows appear to promote economic growth in developing as well as OECD countries. Borenzstein, De Gregorio and Lee (1998) find (hat the positive effect of FDI can be detected when the recipient countries have a sufficiently high level of human capital.

FDI and other types of capital flows into developing countries started to pick up momentum in the 1990s, making it highly desirable to look at the evidence based on more recent data. Reisen and Solo (2001) examine six types of capital flows: foreign direct investment, portfolio equity flows, portfolio bond flows, long-term bank credits, short term bank credits and official flows. They employ a dynamic panel regression framework to deal with potential endogeneity and missing variable problems and cover 44 countries over the period 1986-1997. Of the six types of capital flows, only two, namely FDI and portfolio equity flows are positively associated with subsequent economic growth rates.

Other studies have looked into the effects of different types of capital flows on domestic investment (and hence indirectly on growth). Bosworth and Collins (1999) analyzed such relationships using data covering 1975-1995. focusing on variations within countries over time rather than variations across countries. These authors first removed the country means from the data, and then regressed investment and savings shares on various forms of capital inflows (relative to GDP). They found that more FDI and bank lending are positively associated with increases in domestic investment.

The World Bank's Report on Global Development Finance (2001) replicated the Bosworth and Collins study using a data set with more countries and a longer time period (1972-1998). It found that the association between FDI (or other long term capital inflows or bank lending) and domestic investment is stronger than between short-term debt and domestic investment. The association between portfolio capital and domestic investment is not statistically significant.

In nutshell, across different studies surveyed here, FDI is one form of capital inflows that tends to be found positively associated with domestic investment and domestic growth in a relatively consistent manner. Other forms of capital inflows could also have a positive relationship, but their effects tend to be less robust or less strong.

Risks of Globalization of Finance to the Developing Countries

Internationa! financial integration should, in principle, help countries to reduce macroeconomic volatility. The survey presented in this section, suggests that developing countries, in particular, have not attained this potential benefit. Recent crisis in some MFIs, also suggest that financial integration may in fact have increased volatility (Kose, Prasad, and Terrgnes, 2003).

During the late 1980s and early 1990s major economic reforms were undertaken by Mexico, with liberalization and privatization policies replacing the earlier model of state-led growth. The state, then, was described by World Bank and IMF as a 'model economy' worthy of emulation to other Latin America countries. As a fallout of these neo-liberal economic policies, foreign investors started investing heavily in Mexico and over $90 billion flowed into the country during 1990-1993 (two-thirds of which were in the form of portfolio investments) (Singh, 1999). The majority of these inflows were short-term and aimed at making quick profits through financial speculation on stocks and other securities in the financial markets of Mexico. Only a small portion of portfolio investments was used to create new physical assets, such as factories or machinery. Thus, the gains from the foreign investments were more illusory than real. Within a span of few months (in 1994) the so-called 'model economy' found itself in a serious financial crisis.

Just two years after Mexico faced currency turmoil. Southeast and East Asian countries were engulfed by a similar crisis in mid - 1997. The currency turmoil first started in Thailand and rapidly spilled over to other countries in the region. The Indonesian rupiah, the Malaysian ringgit, the Philippine peso and South Korean won-all came under attack. The spillover impact (also known as 'contagion effect') of the Asian currency crisis was experienced in Eastern Europe as well, where Czech Koruna was affected. The turmoil which initially erupted as a result of the currency devaluation, soon developed into a major financial crisis in the Southeast and East Asian countries. In other countries of the region, for instance China and Vietnam, where FDI flows dominated net private capital inflows, the impact of the crisis was negligible (Singh, 1999).

Various attempts have been made in the recent past to understand the causes behind the sudden collapse of the Southeast and East Asian economies. Some analysts have blamed the domestic policies of these countries, while others have questioned the role of global finance in perpetuating the crisis. However, the fact is that the crisis was the product of a combination of external factors, which globalization aims to integrate.

Many analysts have also called for careful phasing and sequencing of import and external financial liberalization policies. They argue that financial liberalization policies are less likely to succeed in the absence of a sound macro-economic situation (Correa, 1996).

It is apparently clear (from the points raised above) that, international capital flows can be very risky. However, different countries experience different degrees of risks, and this may be systematically related to the quality of domestic governance, financial regulation and supervision as well as other macro economic policies (Kaminsky and Reinhart, 1999; and Arteta, Eichengreen and Wyplosz, 2001).

Conclusion

We quite agree, with the conclusion of Fisher (1999) in his analysis of the financial crisis in emerging markets when he says "globalization is here to stay." Nevertheless, in our view, the main point here is not the question of whether the developing countries should be globalized or not, but rather how can the}' be repositioned to take advantage of the globalization trend.

The empirical evidence reviewed in this paper has not established a definitive proof that financial integration has enhanced growth for developing countries. In other words, there is nothing inherently good or bad about capital flows to developing countries. The political and institutional context in which financial flows take place is an important determinant of the desirability of increased financial flows. Globalization of financial markets has taken place with a shift of power into the hands of private lenders and international financial institutions, in particular, the IMF, This process has undermined the ability of economically and politically disadvantage^ groups (or countries) to voice their collective interest.

Based on the benefits and risks of financial integration, raised in this paper, it might not be essential for a developing country to develop a full set of sound institutions matching the best practices in the world before embarking on financial integration. Doing so might strain the capacity of the country. An intermediate and more practical approach could be to focus on making progress on the core indicators noted above, namely good governance (through transparency, control of corruption, rule of law) and financial supervisory capacity.

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