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Margaret Johnson-Hilili

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Effect of Financial Globalization on Developing Countries: Some Empirical Evidence by Eswar S. Prasad et al[++] - A Review

Margaret Johnson-Hilili*

I. Introduction

The wave of globalization since the mid-1980s has been marked by a surge in capital flows among industrial countries and more outstandingly, between industrial and developing countries. Although capital inflows have been associated with high growth rates in some developing countries, a number of them have also experienced periodic declines in growth rates and significant financial crises that have had substantial macroeconomic and social costs. As a result, a strong debate has emerged amongst policy makers on the effect of financial integration on developing economies.

Developing economies' financial linkages with the global economy have risen significantly in recent years. However, a relatively small group of these countries has garnered a satisfactory share of private capital flows from industrial to developing countries, which surged in the 1990s. Despite the recent sharp reversals in such capital flows, structural factors, including demographic shifts in industrial countries are likely to provide an impetus to these flows over the long and medium term.

The main objective of the paper was to provide an assessment of empirical evidence on the effect of financial globalization on developing economies. It focused on three related questions: Does financial globalization promote economic growth in developing countries?; what is its impact on macroeconomic volatility in these countries?; and what are the factors that could help countries benefit from financial globalization?.

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* Hilili *is an Assistant Economist in the Research and Statistics Department of the Central Bank of Nigeria, Abuja*

II. Summary of the Paper

The paper centered around the idea that financial globalization was an aggregate concept that referred to increasing global linkages created through cross border financial flows. The authors used *dejure* restrictions on capital flows and actual capital flows across national borders in measuring the extent of a country's financial integration with the global economy. While these two measures of financial integration are related, they denote two distinct aspects. The capital account restrictions measure reflects the existence of *dejure* restrictions on capital flows, while the financial openness measure captures de facto financial integration in terms of realized capital flows. By either measure, the difference in financial openness between industrial and developing countries is quite stark. Many industrial countries have attained a high degree of financial integration, particularly in the 1990s. While this measure also increased for developing economies in that decade, the level remains far below that of industrial economies.

The authors, however, outlined the benefits of financial globalization on developing countries. The benefits were first, the substantial increase in the volume of cross border capital inflows from industrial to developing countries as a result of both "push" and "pull" factors. The push factors are business cycle conditions and macroeconomic policy changes in industrial countries; for example the increase of institutional investors in industrial countries and demographic changes, such as the relative aging of the population in industrial countries. The pull factors arise from changes in policies and the fact that developing economies have become more open. This has witnessed considerable liberalization of capital accounts and domestic stock markets as well as large scale privatization programs.

Second, financial globalization could in principle help to increase the growth rate in developing countries through a number of direct and indirect channels. The direct channels include: augmentation of domestic savings, reduction in the cost of capital through better global allocation of risk, transfer of technology and managerial know-how from advanced to developing countries, and development of domestic financial sectors. The

indirect channels are 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.

The third benefit of financial globalization is that it leads to increase in per capita income. For instance from 1970 to 1999 the average per capita income of more financially-open (developing) economies grew almost six times more than the corresponding increase for less financially-integrated economies. This pattern of higher growth also applied to consumption and investment growth.

The authors also presented the demerits of financial globalization on developing economies. The first is that it affects the management of consumption volatility. The evidence presented in the paper, which showed that although the volatility of output growth on the average declined in the 1990s, the volatility of consumption growth relative to that of income growth on the average increased for the emerging market economies. This period coincided with the period of rapid increase in financial globalization. In other words, the authors argued that procyclical access to international capital markets appeared to have had a perverse effect on the relative volatility of consumption for financially-integrated developing economies.

The paper also noted that financial globalization leads to currency crises among developing economies. This was attributed to: first, the tendency of international organizations to engage in momentum trading and herding which could be destabilizing for developing economies. Second, international investors together with domestic residents engaging in speculative activities could harm the currencies of developing countries, thus causing instability and; third, the inability of government to assign sufficient weight to the interest of future generations.

The latter parts of sections three, four and five of the paper were devoted to the presentation and explanation of a model designed to calculate the potential welfare gains arising from financial globalization. The paper noted that international financial integration could result in potentially large

welfare gains as it allows domestic residents, firms and countries to smooth fluctuations in their consumption/revenue by diversifying away country-specific risks. For example, during recessions, countries can borrow from international markets and mitigate the adverse impacts of declines in aggregate output on consumption and investment. During booms, they can lend to other countries and/or pay back the loans they borrowed during the recessions. However, they asserted that the empirical evidence did not fully establish a definitive proof that financial integration had enhanced growth in developing countries.

The paper concluded that financial globalization, in combination with good macroeconomic policies and good domestic governance is conducive for growth. Thus, countries with abundance of human capital and good governance tend to attract more foreign direct investment (FDI). Transparency of government operations was also seen as having a strong positive effect on investment inflows. Corruption was, however, identified as having a strong negative effect on FDI inflows.

III. Comments and Lessons for Nigeria

The authors' foresight in discussing this topical issue is most commendable. Although Nigeria is relatively integrated with the global economy, it is a late starter in the area of financial integration even though the economy has remained open over the years. The non-internationalization of the capital market has prevented the economy from exposure to financial crises. However, some of the issues raised in the paper are still valid for the long-run growth of the Nigerian economy.

At the current state, Nigeria's share of global trade has been very low due to her low export capacity. This is largely accounted for by undue dependence of Nigeria on crude oil exports, which has limited the scope for the diversification of the economy and, in turn, exposes the economy to terms of trade shocks. Also, the domestic financial market is still rudimentary and has not kept pace with developments in the global financial markets. This informed the introduction of the recapitalization exercise for the deposit money banks by the Central Bank of Nigeria in line with international best practice.

The various key measures highlighted such as consumption volatility, currency crises and corruption should be monitored by Nigeria if it is to derive maximum benefits from financial globalization. Admittedly, transparency of government operations exerts a positive effect on investment inflow in the country. This has become more evident since the setting up of some institutions such as the Economic and Financial Crimes Commission (EFCC), Independent Corrupt Practices Commission (ICPC) and Code of Conduct Bureau (CCB), amongst others, by the Federal Government. On the other hand, that a high degree of corruption affects the composition of a country's capital inflow is an important point to note.

Despite these effects, excessive growth in investment financed by foreign capital when domestic savings are low and the macro economy is unstable could result, especially in volatility of consumption and, hence, current account deficit.

The authors failed to mention that rapid financial globalization can alter the environment confronting policy makers in the conduct of monetary and financial policies. The continuous inflow of capital if not properly utilized could lead to increase in domestic interest rates, with attendant inflationary pressures. This could also lead to a sustained appreciation of the real exchange rate, which is counter productive for external sector competitiveness.

Also, another important issue which the paper failed to discuss is the adverse consequences on the domestic economy if a country does not develop the required absorptive capacity to utilize the influx of capital. However, this article is really informative as it will guide federal government policies towards ensuring that the country derives maximum benefit from financial globalization.

IV. Conclusion

As discussed in the paper, financial globalization has both positive and negative effects, which are opportunities and challenges. Although, it was difficult to distill new and innovative policy information from the review

of evidence, analysis in the paper showed that good institutions, quality of governance and macroeconomic frameworks are important in helping developing countries to derive the maximum benefits from financial globalization.

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