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GLOBALIZATION OF THE FINANCIAL MARKETS AND THE APPEARANCE OF CONTEMPORARY FINANCIAL CRISIS

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Abstract

This paper analyses the positive and negative aspects deriving from the process of globalization of the financial markets. The financial globalization has numerous advantages for the national economies as well as for the investors, but on the other hand, it also causes many changes in the structure of the markets creating certain risks and challenges for the market participations and politicians.

The purpose of this paper is to point to the extent of connection between the financial globalization and the appearance of the contemporary financial crises in the world.

Introduction

The terms financial globalization and financial integration are basically two different concepts. Namely, the financial globalization is a process which covers the increased global connections of the interboarder financial flows. Whereas the financial integration covers the individual connections of one country to the international capital markets. Anyhow, these two concepts are closely connected, because the increased financial globalization is purposely connected to the increased financial integration.

The results of different researches point to the fact that the process of globalization has first started in the developed countries, whereas the developing countries and the transitional economies have undergone the process more slowly because of the fact that the investors have been careful about the possible risks which can come as a result of this process.

There are many useful aspects which derive from the process of financial globalization. They refer to the development of the financial system, the possibility of the investors to realize productive investment projects, improved financial infrastructure, improved financial growth ect. When the participants in the international financial markets take the responsibility of making decisions to perform certain activities, they also should take into account the risks which can appear as a result of the financial globalisation.What is meant is that certain countries or regions can be economically unstable and in the globalize world we live in, the imperfections of a market segment or country can be easily transferred to other regions.

In the main part of the paper the stress is put on the risk of the appearance of financial crises as a result of the increasing globalization of the world financial market.

Understanding the basic concepts of financial globalization and financial integration

The process of globalization refers to the closer integration of the countries and people in the world and it is carried through by great reductions of the costs in the processes of transport and communication, as well as by removing the man-made boundaries among the flow of goods, services, finances, knowledge and moving of the people outside the borders.

It is very important to be noted that the growing development of the telecommunication and computer technologies, production of new products as well as the increased spreading of the international financial flows, have important influence over the achieved degree of development of certain countries. The changes in these areas enable the world market participants to get information on much easier way concerning the estimation, analysis, and managing the financial risks, as well as efficient managing of the transactional activities which are carried through in the financial centers in Asia, Europe and Western hemisphere.

Having in mind the above mentioned facts, we can certainly tell that the world financial markets today are more efficient compared to the past. It is due to the improvements in communication and informational technology whereas the new instruments and techniques enable the financial and non-financial firms to manage the new financial risk more efficiently.

From the 60-ties of the last century the financial markets in the world integrate more and more. As a result of this trend the financial institutions are more oriented toward the international markets. In 1960 only eight American banks have had their branches abroad, whereas today more than hundred banks have branches everywhere in the world. Two out of three leading Macedonian banks have foreign owners and 44% of total finances of the Macedonian banking system are owned by foreigners. (M.Petkoski, 2004)

Concerning the fact that the terms financial globalization and financial integration will be frequently used in this paper, it becomes inevitably to stress out that these two terms have opposite meaning. Namely, financial globalization is a process which refers to the increased global connections to the international financial flows. Whereas financial integration refers to the individual connections of one country to the international financial markets. Anyhow, these two concepts are closely interrelated because the increased financial globalization is connected to the increased financial integration.

Numerous indicators of the level of integration of the countries to the international markets show that the process of globalization has started first in the developed countries, whereas the developing countries and the transitional economies have undergone the process more slowly because of the fact that the investors have been careful about the possible risks which can come as a result of this process.

In this context we can mention that the researchers use different indicators of measuring and indicating the level of financial integration so that they can determine the level of integrating of different countries to the world financial market in a more precise way.

One of more influential approaches is defining the connection of the national savings and investments. In the case of perfectly integrated financial markets, there is no need of the national investments to depend on the national saving since the countries can take loans from abroad. In their analysis Feldstein and Horioka (1980) came to a conclusion that even though the capital controls have been removed from the developed countries in the early 70-ties the connection between the national savings and the investments has remained surprisingly high.

Other researchers analyze the financial integration through the use of the capital controls on national level. This way of presenting, points to the much higher financial openness of many countries but it still faces many problems. Even the use of such indicators is preferred in practice because of their availability through annual reports of IMF, still there is not any difference made between more and less important forms of foreign currency controls and other forms of barriers in the market integration are not taken into account (e.g. national tax regimes). Such indicators show the national policies and not the rate of the global integration (removing capital controls from USA, Japan and EU countries were more decisive for the future than the rest of the political decisions).

Apart from the existing problems of the main indicators there is no doubt that starting from the 70-ties the global integration of the financial markets is growing as a result of the fact that much larger industrial economies and few financial centers and developing countries appear because of the global phenomenon. Almost all developed countries, sooner or later followed the example of the USA which in 1973 removed the capital controls. In the late 80-ties and 90-ties some countries from Latin America and Eastern Asia removed capital flows as well. Big changes of the controls of the capital flows happened between the industrial countries and even more between developed countries, developing countries and transitional economies. For example in the 1970-ties and 1980-ties total capital flows of these countries were 1% of their total annual income. But in 1997 the financial flows have reached the level of 4% of their total income (M. Knight, 1999).

We can surely tell that the risk for openness of the developing countries to the global financial market was accompanied by appearance and existence of financial crises. Namely, the contemporary financial crises which existed in many developing countries

(As Mexico, Eastern Asia, Russia, Brazil and Argentina) were important proofs of the fact that the consequences of the financial globalization were spread unevenly in the developing countries.

The potential benefits and risks of the process of globalization of the financial markets will be explained in the text bellow.

Benefits and risks of the financial globalization

The potential benefits of the financial globalization are already well known. They refer to an easy transfer of the savings between countries creating possibilities so that the investors can provide finances for productive projects, promoting development and opening new job positions. At the same time the process of financial integration[1] influences the creation of healthy competition of the domestic banking system.

One of the main benefits of the process of financial globalization is the fact that it can lead to development of financial system. As we have mentioned before, the financial system that functions right, provides finances of the investors through which they can realize productive investments.

The process of financial globalization can lead to improved functioning of the financial system in two different ways. First, it enlarges the opportunity for extra funds and second, it improves the financial infrastructure which results in reducing the problem of incomplete information. As long as there is incomplete information it is possible that moral haphazard and unfavorable selection can be made which can lead to disruptions of the market operations.

The existence of new sources of finances means that the investments do not depend only on the domestic funds because they can take loan from countries interested to invest in their own country.

The potential benefits from foreign direct investments does not only mean providing finances but it means developing new technologies know-how and training of managers and employed people who can contribute to enlarge the productivity and economic growth of the country in which these funds are invested.

Another contribution of the financial globalization is the fact that the creditors and investors can provide much better conditions for investments. Namely, the companies can finance their physical investments in a cheaper way, whereas the investors can differentiate portfolio risks of their priorities easily on international

1) The terms financial globalization and financial integration are basically two different concepts. Namely, the financial globalization is a process which covers the increased global connections of the interboarder financial flows. Where as the financial integration covers the individual connections of one country to the international capital markets. Anyhow, these two concepts are closely connected, because the increased financial globalization is purposely connected to the increased financial integration.

level. For example, the prices of the real estate in Asia were high and went lower before the crisis leaving the banks with lots of nonfunctional loans.

The financial globalization can influence the functioning of the financial system through improving the financial infrastructure. The improved financial infrastructure as one significant contribution from the financial globalization means that the creditors and the investors act in much more transparent and efficient financial system. As we have mentioned before, it is a system which reduces the appearance of the problems of unsymmetrical information, moral haphazard and adverse selection but it enlarges the benefits of potential loans also. Foreign participants of financial markets, deposers and share-holders need to be supplied with proper, real and comparable information so that they can easily estimate the bank condition. It supposes transparency which comprises of providing and keeping consistent and accurate accounting standards, satisfying standards for financial reports and useful information. In this sense, IMF develops standards for better practices of transparency in the monetary and financial policies. This standard can help each country to estimate its own practice as well as to take measures for its improvement when it is necessary.

Further more, we should also mention that obviously there is strong connection to the growing financial globalization and the level of economic development. For instance, the industrial countries are more financially integrated than the developing countries. Similarly, when we talk of developing countries, the economies which are more financially integrated develop rapidly that the less integrated economies. Anyway, we can not exclude the opportunity of appearance of counter movements on the rates of economic development and the degree of financial integration of different countries.

The next table shows the fastest developing countries and countries which have lowest (reducing) rate of development in the period 1980-2000. This information should be used to present the connection between the financial openness and the rate of development of these countries.

Table 1: Developing countries with highest and lowest rate of development from 1980 to 2000 and their condition of financial openness.

	countries with highest rate of development (1980-2000)	Total change of income in presents	More financially integrated?	countries with lowest rate of development (1980-2000)	Total change of income in percents	More financially integrated
1	China	391.6	Yes/No	Haiti	-39.5	no
2	Korea	234.0	yes	Nigeria	-37.8	no
3	Singapore	155.5	yes	Nicaragua	-30.6	no
4	Thailand	151.1	yes	Togo	-30.0	no
5	Botswana	135.4	no	Venezuela	-17.3	Yes/no
6	Hong-Kong	114.5	yes	South Africa	-13.7	yes
7	Malaysia	108.8	yes	Jordan	-10.9	yes
8	India	103.2	Yes/no	Paraguay	-9.5	no
9	Chile	100.9	yes	Ecuador	-7.9	no
10	Indonesia	97.6	yes	Peru	-7.8	yes

Sources: Prasad, Edward, K.Rogoff, S.Wei, M.A.Kose. (2004) "Financial globalization, growth and volatility in developing countries", Working Paper 10942, Cambridge.

Table 1 Shows that the financial integration is not a necessary factor for maintaining high rate of development of certain economies. That can be seen in China and India where the rate of development is high even though there is restricted and selective liberation of their capital accounts. For example, China is open for foreign direct investments but not for other capital flows. Same, Botswana has managed to maintain high rate of development even though it is not open for foreign financial investments. On the other hand, Jordan and Peru have low rate of development even though they have been open for foreign investments.

Many researchers came to a conclusion that even though the fact that the financial integration can cause flow of foreign investments it is very little possible that it will offer much higher rate of economic development. For example, in a case of weak and inefficient domestic managing, the financial integration can cause overflow of the home finances, thus influencing the reduction of the rate of development of the home economy.

Thus, the financial integration of certain countries can be realized combined to other relevant factors which will enable the developing countries to maintain higher rate of development.

Apart from the already mentioned benefits of the process of financial globalization there still exist certain negative aspects. One of the potential risks of the process of financial globalization is the disruption of the economic stability of certain countries or regions. The dynamics of the market is changing in such a way that is enhances the possibility of appearance of important market changes because of the development of new technologies, financial instruments and techniques improved the connection between the market and market participants all over the world. As a result of that, it is very probable that in the globalize world, the disruptions of one market segment or country can be transferred into some other regions.

According to Stiglitz (2002) the global instability means great expenses. The globalization can be changed in such a way that all countries (and not just some institutions - World Bank, IMF) will participate in the conduction of the policies which influence their economies. Only in such a case, a global economy which will support the development making the changes less painful can be created.

Financial globalization and the appearance of financial crisis

As a result of the process of globalization of the financial markets, the enterprises and foreign investors of the world have enlarged the financing of international financial markets significantly.

As it was already mentioned, the process of financial globalization through directing the funds to their most productive use can help the developed and developing countries to create much higher standards of living. But the sudden turnover of the capital investments can present a threat to the national and international stability.

The most recent researches show that the chances of one country to experience financial crisis become higher because of the process of globalization most certainly because of the fact that with the newest technological inventions the funds can be imported and exported from one country.

When we talk of the connection between the process of financial globalization and financial crisis it is preferable to mention that there are more channels through which the financial globalization can cause financial crisis. If one country liberates the financial system it will become dependent on the market discipline of foreign and home investors. They contribute to improving the conditions of the financial markets of the open economies, but this market discipline of the foreign investors means creating market troubles. In this case, vulnerability of the country becomes high when the country opens its financial sector to foreign markets.

The financial globalization can cause crises in a case of imperfect international markets which can cause crisis even in countries that have solid financial system. Such markets can generate irrational behavior, speculative assaults and similar in conventions. For example, in a case when the investors perform speculative assaults on the domestic currency with a belief that the course is unstable, a balance crisis can appear.

Furthermore, a financial crisis may appear in countries with strong financial system even in a case when the international financial markets function properly. But as a result of the exterior conditions which are important determination markers of the capital flows in the developing countries, some problems may arise. For example, the level of world interest rates is a significant determination marker of the capital flows in Asia and Latin America during the 90-ties.But if the country becomes dependent on foreign finances, the sudden stop of the income can create certain financial difficulties and appearance of financial crisis as was the case with the mentioned countries.

When we talk of the influence on the financial globalization over the escalation of the financial crisis we can mention Asian financial crisis in 1997-98. Some more examples would be: the crisis of the European monetary system in 1992-93 and Mexican crisis in 1995. Even though as a cause of this crisis the financial markets were mentioned, the real causes are to be found in the disrupted balance of the economy and weakness of the home politics.

Even the problems during the crisis were different from one country to another; there were still some common characteristics. The initial manifestation of the crisis was accompanied with great flow of finances, decreasing the foreign currency reserves and investments, collapse of exchange market and depreciation of the home currency. All of this led to inevitable reducing of the economical activities and taking back the finances which might lead to devastation of the economy.

During the crisis in Thailand, Indonesia, Malaysia and the Philippines one dominant problem was reducing of the increasing rates of export and increasing the deficit of the banking account. It was a result of the flow from the foreign funds because the investors knew that these economies did not have enough capacity to service their debts. That meant that the risk to refund the money from the loan did not make the investors give their money away. In 1997 the countries from the Eastern Asia faced massive flow of foreign private funds present in their economies during the 90-ties.

This crisis differs from the others in that way that it first appeared in the Asian countries and then it speeded throughout the region. The appearance of the crisis was first felt in Thailand, next in Philippine and Malaysia and finally Indonesia and Singapore. But the crisis speeded outside the Asian region. The financial disruption got international character and speeded in Latin America, Europe, Baltic region and Russia.

The consequences of the financial disruptions in Eastern Asia were not felt only in functioning of the financial markets. The Asian crisis influenced the diminishing of the foreign economy and economic development briefly in certain countries. It was felt in Japan, and even in Canada and USA.

Do and how the governments of certain countries influence the use of the positive effects on the process of financial globalization?

The experiences from practice demonstrate that the countries which have strong macroeconomic policy, transparency of home governing are less reluctable to the risks of the process of financial globalization. The combination of such policies means well constructed national and international institutions[2] which bring to increasing home economy and the process of globalization.

The capability of one country to attract and use the effects of the international investments depends on the quality of the valid management. Furthermore, the existence of high rate of corruption can influence the structure of the capital flows in the country, making it vulnerable to the risks of speculative attacks and the effects from the transmission of the shocks from one into another country.

The transparency of the managing operations is an element of good government. This element is important when reaching a decision in which country should the portfolio investments from the international funds go to. They are directed toward countries which have high level of transparency. The level of transparency can influence the rate of instability of the capital flows of the developing countries.

In this context we can say that the financial crisis proves that the countries with weak and inappropriate financial regulation and supervision have experienced banking and currency crisis. If a country liberates its

2) On national level this means social and financial security (safest nets), whereas on international level it refers to the existence of certain international institutions (IMF and Basle Committee of Banking Supervisors) IMF Staff, 2000 p.12.

home capital account before it introduces adequate financial supervision then it is more open for financial crisis. The result of this activity can be either overloading from the capital markets or increase of debts when the Government guarantees these loans. Such activities can result in appearing weakness and disruption of the balance condition of the governmental and corporation sector which can influence the health of financial institutions. That is why it is necessary for the country to introduce appropriate financial regulation and supervision before the liberalization of the capital account.

The capability of one country to use the advantages of the financial globalization and its vulnerability to the international capital flows can depend on the quality of the macroeconomic system and home institutions.

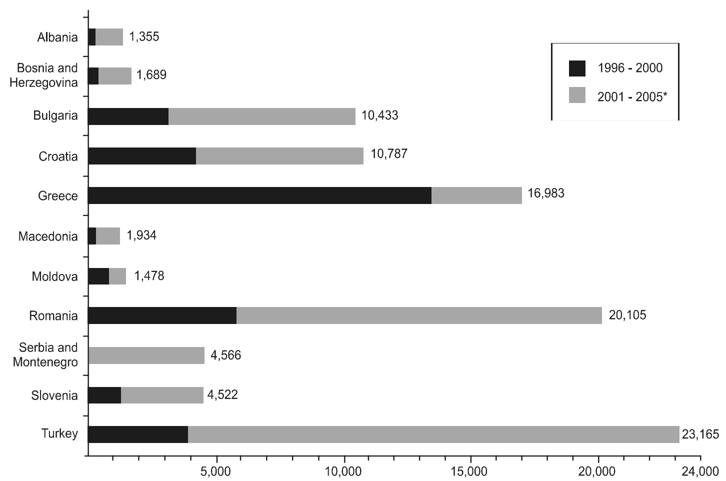
The countries should use the advantages and lower the negative effects by focusing on improving the transparency, control of corruption, the role and use of the acts and the capacity of the financial supervision.

What is the rate of globalization of Republic of Macedonia?

This paper uses certain markers from the foreign economy and FDI which point to the fact that in today's globalize world, R.of Macedonia does not represent a globalize economy. This conclusion is affirmed by certain data which confirm the real condition in R.of Macedonia. They refer to the foreign investments, the judicial conditions, the infrastructure, export deficit and the problems in the real and economical sector.

For example, the flow of FDI in Macedonia is considerably lower compared to the values of other countries in South-Eastern Europe. (Figure 1)

Figure 1
Total FDI inflows in Southeast Europe, EUR mil



Source: Southeast Europe Investment Guide 2006

Note: Data for 2004 is preliminary, while for 2005 is a forecast

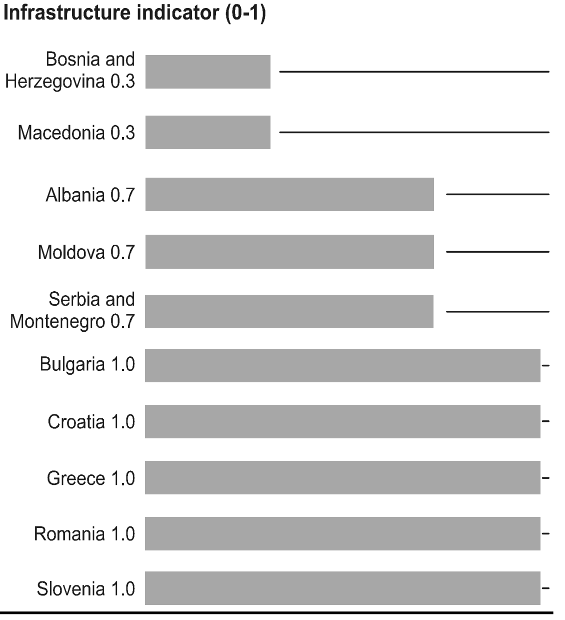
Namely, foreign investors do not invest in Macedonia because the Macedonian market is small and not attractive for foreign investments which are contributed by the political instability in the past period which enlarged the risk of investments. This is why it is necessary to work on development of carefully chosen sectors which will be the best selection for a great foreign investor who would like to invest in Macedonia. Other reason for the low rate of FDI is the existence of inefficient jurisdiction. Today, the reforms in juridical system are of great importance. For attracting foreign investors in our country it is necessary to fasten the professionalism and independence of the juridical system, expedite of the subjects by initiation of rigorous deadlines and sanctions for delay as well as greater efficiency in solution of the administrative suits. It is necessary for the juridical system to be efficient in its work, because for example, the decision which refers to realization of the rights of the investors after five years brings a message to the potential investor to stay away from a country in which the judicial system is inefficient.

One of the key factors for attracting foreign and local investments is the improving of the efficiency and availability of the infrastructural services and their lawful framework. Figure 2 shows the infrastructural indicator which measures the infrastructural efficiency and regulation. This indicator takes into account the following three infrastructural indicators:

- Availability of independent telecoms regulator
- Availability of separation or railway accounts
- Availability of independent electricity regulator

Figure 2

Infrastructure indicator



Source: Southeast Europe Investment Guide 2006

The figure shows that Bulgaria, Croatia, Greece, Romania and Slovenia have much better performances compared to Macedonia and B and H.

For promoting the investment performances of Macedonia since 2005 here functions the Agency for Foreign Investments of the Republic of Macedonia (MacInvest) which started its activities in January 2005 under a law adopted in June 2004. It is a state institution, mainly focused on providing information services and assistance to investors. MacInvest's activities (Investment Guide for Southeast Europe 2006):

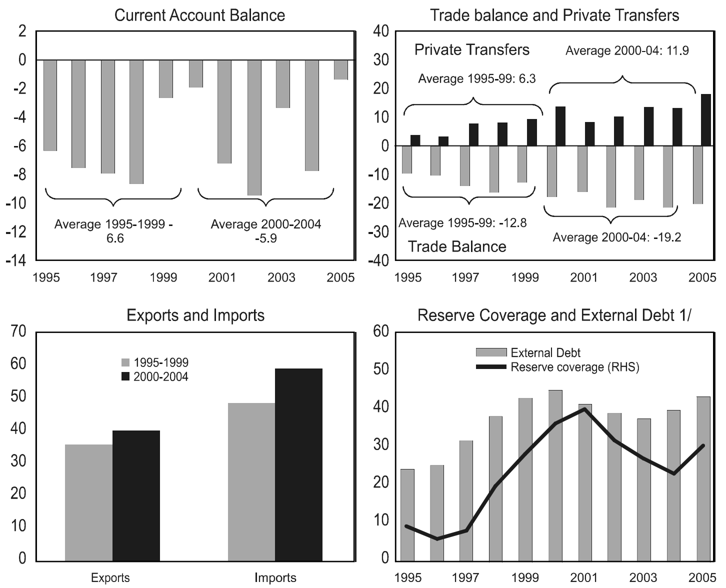
- FDI promotion and attraction according to best practices;
- High professional services to investors in pre-investment, investment and reinvestment phases;
- Image building of the country as an investment destination;
- Promotion of the regions of the Republic of Macedonia and stimulation foreign investors to use products and services of Macedonian companies;
- Identification of the sectors that offer best perspectives and their promotion;
- Development and implementation of innovative and proactive events on targeted markets;
- Analyses of the investment climate and proposals for legislative changes aimed at its improvement;

Stimulation and assistance to green-field investments and technological parks.

The rate of globalization of R.Macedonia can be presented by the export that is realized in our country to the foreign markets. Even though, Republic of Macedonia is a small country, still its contribution to the world economy is inadequate for maintaining its purposes. Besides the fact that there are certain export improvements, the large and continuously present deficit of the capital account is still a problem for the competitiveness of our country. Namely, during 1995-2004, the deficit of the capital account has approximately been 6.3% of GDP. In the first half of this period, the economy deficit has approximately been 13% of GDP, whereas during the second half of the period the deficit increased to 19% of BDI. In 2000-2004, the export has increased to 10%, whereas the import has increased only 4%.

As a result of the large current account deficits, external vulnerabilities have increased during the past ten years, although external debt levels remain manageable. During 1995-2004, the sharp increase in external debt is explained by the large current account deficits and the need to accumulate reserves. The political crisis of 2001 dried up external financing, and the large current account deficits caused a steady decline in the reserve coverage ratio. The condition of the current account and external debt are presented on Figure 3.

Figure 3
Current Account and External Vulnerabilities (As share of GDP)



Source: IMF, State Statistical Office of Republic of Macedonia

In order to get clear image of the low export performances of R.of Macedonia we will make a comparison to some transitional economies in the region (Figure 4). As we can see from the figure, Macedonia has lost its participation in the world import especially on the American market. Even though there are certain improvements in 2004 still the values are not even close to the income realized in 1995.

Figure 4
Export Market Shares (in %)

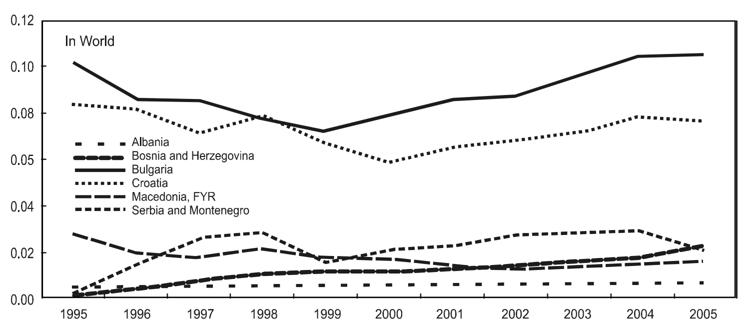
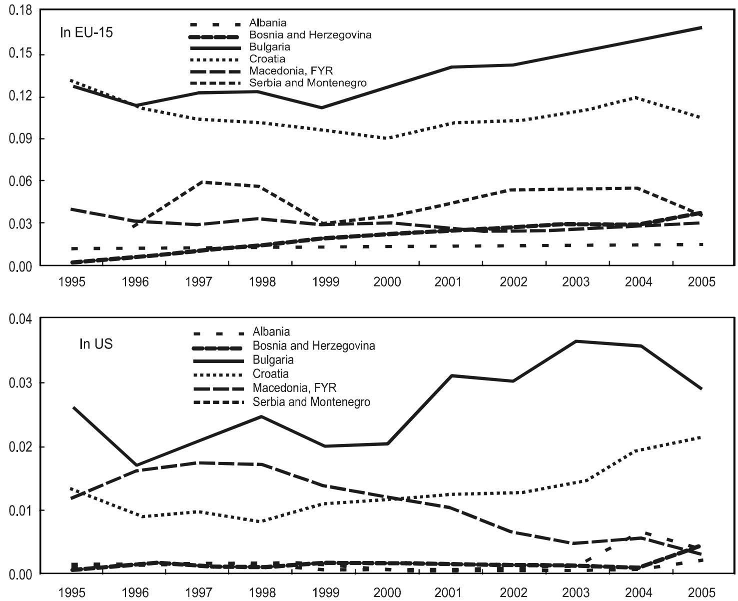


Figure 4
Export Market Shares
(in %)



Source: IMF, State Statistical Office of
Republic of Macedonia

Currently Republic of Macedonia faces numerous problems in the real and economic sector. More precisely, there has been a reduction of the industrial manufacture and of FDI, increasing of the economic deficit, large unemployment...

At the same time, fiscal condition of Macedonia is very vulnerable which is due to many factors such as: low rate of investment, reduced consumption, fall of manufacture, low economic development.

Some of the problems Macedonia faces with can be identified as part of the causes which contributed to the appearance of Mexican and Asian crisis in the 90-ties. Those problems are: deficit of the current account, rigid regimes of the foreign currency courses, high interest rates, existence of corruption, absence of FDI etc.

Such and similar problems in the real sector can be transferred to the financial sector and can produce a financial crisis. In this sense, the high debts of the large industrial capacities in the country present binding foreign loans which is a condition for existence of debt crisis.

In order to overcome this condition, the governmental policy should be directed toward improvement of the "capacity of administration", i.e. the employees in the institutions should provide quality services for the business. At the same time, the Government should make a distance from the economy, from direct interference in reaching decisions, especially in employing and investing.

In order to provide sustainable economic development it is necessary, in any case, to improve the investment climate in the country, reduce the rate of unemployment, increase the capacity of the industry, increase the speed of the structural reforms and reforms in administration, judicial system etc. Solving such problems will contribute to opening of Macedonian economy toward the outer world which will provide conditions for its globalization and integration in the world economy.

Conclusion

Even though the globalization of the financial markets is a process from which the participants on the international financial stage can benefit, they should also take into account the risks of this process. The financial globalization improves the financial system by offering extra funds and improving the financial infrastructure which means income and economic development. This process can cause disruption of economic stability of certain countries because of market disruption which transfers from one country into the other.

An important risk from financial globalization is the appearance of financial crisis. It was the case with Eastern Asia and Latin America in the 90-ties, which affected even the economic development of the region and even of Europe, USA and Canada.

The countries should use the advantages and lower the negative effects by focusing on improving the transparency, control of corruption, the role and use of the acts and the capacity of the financial supervision.

Relatively speaking, Macedonia is closed country, so that its financial system in the past period depended on the market discipline of the foreign and domestic investments. As we can see from many emerging markets that have experience with financial crisis opening of the financial sector toward international financial markets create danger for appearance of market inconveniences which will have negative influence on the vulnerable Macedonian economy in a short period.

In any case, we shouldn't let the country to become dependent on foreign capital because if capital flow sudden stop or if foreign capital outflows of our country there can be certain financial inconveniences initiating appearance of financial crisis. But the fact that Macedonian economy should be open to foreign investments and domestic investors is still present.

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