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# STABILITY *VERSUS* INSTABILITY IN THE CONTEXT OF FINANCIAL GLOBALIZATION

**Roxana HETEŞ** [*]

***Abstract:*** *The financial environment has undergone a profound transformation in the context of globalization, financial flows of scale, diversification of financial instruments, increasing interdeperndence of national financial markets, being of critical importance. However, while global financial markets play a crucial role in the distribution of global capital, they do so in a way that can have profound negative implications. This paper tries to demonstrate that, globalization is capable of causing instability in the whole world, enabling broad crises, and, not least, increasing the danger of recession in the world, based on the manifestation of the global systemic risk. Knowing the risks and distortions that can affect the stability of the financial sector in the context of financial globalizaton, as well as their consequences, is especially important for the design of the regulation and surveillance process, plus for the formulation of crisis remedial and prevention actions.*

***Keywords:*** *financial globalization, crises, volatility, systemic rik*

***JEL classification:*** *G 15*

## 1. INTRODUCTION

Globalization is the modern term used for describing changes in societies and in the world economy that result from the highly increased international trade and cultural exchanges. In an economic context, we usually find the almost exclusive reference to the trade effects and trade liberalization or free trade. This is a main feature of the contemporary world economy, comprising all the sides of the economic life, as well as a process caused by the competition between the main poles of the international power.

At the basis of the globalization process lie a series of economic, technical, social and political factors that act simultaneously and interrelated at international, regional and national level. Cerna identifies the main factors that influence globalization, at the international level, in the new performing technologies, the

[*] Lecturer Ph.D. West University of Timisoara, Faculty of Economy and Business Administration, Str. J.H. Pestalozzi, no.16, 300115, Timişoara, rhetes@yahoo.com

expansion of modern industries, services' sector development, reducing or removing the national barriers for the international movement of goods, services, technology and capital. At a big extent, those factors also act at regional level, producing thus a tendency of concentration of the economic activity in three main regions: North America, Occidental Europe and Asia. At the national level, the factors identified above determine private sector development, expanding market mechanisms, opening national economies to the exterior, etc. [Cerna, 2008, 12].

The concept of financial globalization takes into consideration the creation of a global money market, a global financial market, a global financial system, whose emergence and development is based on the phenomenon of deregulation of national financial markets, the emergence and development of new financial instruments and expansion of banks and other international financial institutions. Globalization entails the amplification in the volume of financial capital flows as well as the increases of their intensity, processes that can be measured depending on the degree of openness of national financial markets[66], the level of financial gearing[67] and the degree of financial integration[68].

The main feature of globalization is financial deregulation, which consists in the gradual abolition of regulations on trade, in order to facilitate the international movement of capital. This trend began to outline the in the 80s, in countries like Latin America, U.S., Japan and Great Britain, and in the 90s in the continental Europe. Developed countries have waived the restrictions by which controlled entrances and exits of capital, along with strengthening their economies and transition to full convertibility of their currency [Heteş, 2009, 23]. In the context of globalization, capital flows have experienced a real explosion especially in the form of investments made across national borders, as portfolio investment and foreign direct investment [Heteş, 2009, 32].

In the case of emerging economies capital flows' liberalization makes these economies vulnerable to potentially unstable capital flows. Thus, it is possible that removing distortions caused by the movement of capital may not be beneficial because there are other economic distortions, which are compensated by the control of foreign financial transactions. For example, if in a country where there are branches that have in the past been protected from international competition, liberalization of capital cause decapitalization of those branches and the migration of

[66] Opening of national financial markets refers to the elimination of legal restrictions on international financial transactions.

[67] The level of financial gearing refers to the degree of involvement in national and global financial activity that can be measured by indicators such as the share of financial assets in foreign markets, the degree of involvement of financial institutions in foreign domestic financial markets, the share of domestic financial assets in foreign markets, the degree of involvement of national financial institutions on financial foreign markets, the national contribution to various global financial flows, etc.

capital to sectors where there is comparative advantage. Also, liberalization of capital in economies characterized by real wage rigidity leads to an allocation of excessive resources to the intensive capitalized sectors, by replacing labor with capital in manufacturing operations and, therefore reducing the effectiveness of resource allocation, which has a negative impact on the residents' income [Cerna, 2008, 4].

Another feature of globalization is the process of financial disintermediation. This refers to a direct appeal of the operators to financial markets, namely the use of a mechanism of direct funding to the detriment of indirect financing, in order to carry out investment transactions and lending operations. In other words, it represents the shift from one economic system in which financial intermediaries (i.e. mainly banks) represented the main funding circuit, to a market financing process, realized mainly by direct contact between fund holders and applicants. The process of disintermediation, as a feature of globalization, has brought out new risks regarding the exposure of banks to the non-financial sector, either directly or indirectly through problems in financial markets.

Globalization also covers the change in the structure of financial markets and financial intermediaries, since the opening involves national economies openness and the elimination of barriers which separate different compartments of the financial market. More specifically there is a decompartimentation process that establishes bridges between the money market, the capital market and insurance market [Heteş, 2009, 26-27].

In recent decades it could be observed, on the background of financial globalization, an intensification of the consolidation process in developed banking systems, and integration of national financial markets, that have resulted in the formation of companies much more complex than what existed before. The process of consolidation in the banking system may have the effect of increasing banks seen as being too big to fail. This development may cause concerns in countries where the concentration of the banking system is already very high, where the consolidation process is not accompanied by capital market development, which could provide alternative sources of funding. In this case there is a risk that large banks engage in riskier operations, in the hope of receiving support from international groups that they are part of.

At a global view, through the features mentioned above, there be highlighted a number of positive effects associated with the process of financial globalization, in terms of increased direct investment and establishment of strategic alliances between large companies, with beneficial effects on the level of production, development of strategies in accordance with global market trends (based on competitiveness and

[68] The term financial integration implies the existence of a convergence of prices and yields of packages of similar financial assets across different national financial markets.

sustainable development), better allocation of capital markets through the development of more efficient, more transparent and deeper securities' markets, through lower transaction costs and increased market liquidity, through greater diversification of financial systems and the existence of more opportunities for risk reduction, a more efficient allocation of funds from savers to investors and, not least, increasing international agreements in the interest of the world community [Miskin, 2005, 9].

On the other hand, along with these undeniably positive effects, the process of financial globalization has led to an increased likelihood of occurrence and development of large risks. Different categories of factors and vulnerabilities that can affect the performance of national financial systems emerge on the basis of the globalization process and, to the extent that they are not eliminated through appropriate corrective measures, the general trend is to grow and amplify, thus threatening the entire social and economic system.

## 2. VOLATILITY AND RISK FACTORS ASSOCIATE TO THE FINANCIAL GLOBALIZATION

The problem associated with the volatility of the global financial markets is addressed in different ways in literature. Some theories argue that the internationalization and liberalization of capital movements contribute to risk, hence the volatility, reduction. Given the fact that risk is measured by the attached risk premium, this would induce a reduction in interest rates (cost of capital) at the international level. The explanation is based on the possibility of portfolio diversification, because, by liberalization, equity bidders have access to a much larger number of investments, thus reducing the risk for each of the projects, as well as total volatility [Allen, 2005, 13].

Without denying these facts, the global financial market, also confirms a diametrically opposite position, according to which, the relaxation of controls and the liberalization of cross-border capital flows negatively affect financial activity, through increased risks and volatility. The main argument in this regard is the fact that each market is characterized by inherent distortions, which are amplified when it becomes global. Of these distortions, the most important relate to information asymmetry and to the characteristics of the operating environment, to the widespread use of derivatives and to the cross-border activity of institutional investors.

### 2.1 Information asymmetry

Increased volatility caused by information asymmetry may be explained by the fact that, in general, information in financial markets is not perfect and is not equally distributed among market participants. For example, in any credit contract,

the borrower has more information on the expected earnings from the investment project that to be funded, than the credit institution. Another problem concerns the legal and institutional environment in which the contract is signed, meaning that the cost will be even higher as this environmnet is weaker and more unstable [Heteş, 2009, 110].

Syntheticly speaking, information asymmetry has two effects: adverse selection and moral hazard. Adverse selection can be defined as asymmetric information that exists before perfecting a transaction, when the riskier projects are the most active in searching for a loan [Mishkin, 1998, 22]. In other words, creditors, that have little information on the conditions of a given economy, will be tempted to provide funds to borrowers that pay the highest interest rates. If theese higher interest rates are correlated with the project risk, there is a possibility that funds are given specifically to projects of low quality, exposed to an increased risk of failure. If you obtain a better return than the cost of the loan, everyone will be happy and it will be divided between debtor and creditor, but, in the ooposite case, however, losses will be borne solely by the creditor. This situation can be described at best as a problem of moral hazard. Those seeking funds have too little incentives to choose high quality projects, because on the one hand, they will not suffer losses in case of failure, and on the other hand, it is normal to prefer projects that will bring higher earnings, despite the fact they are more risky.

Extrapolating these issues at international level, the problems become more extensive and complex. Information asymmetry is extended when the debtor and creditor countries are different, because the creditor has access to less information as compared to the situation when the two had acted on a local market. Similarly, the there is also an increased cost of obtaining contractual information, the credit institution being put in the position of collecting information about legislation in different countries, which are not familiar, unlike the one in which it is currently operating in. Looking at things from this perspective, risk and volatility of financial operations is higher on global markets than on the domestic financial markets.

## 2.2 High volume of speculative operations

The high volume of speculative operations specific to the global financial market is another potentially volatile factor. Most speculative operations are performed on derivative financial instruments, which strengthen links between different segments of the market and various financial institutions in a manner difficult to identify or quantify[69]. Moreover, low regulatory environment of the international market, increased the opportunities for speculation, jeopardizing the

[69] Even if the main purpose of the derivatives market is to reduce risks related to financial and commercial operations, use of such tools has reached, over time, a strong speculative character, which increases volatility, especially in terms of a broader information asymetry.

stability of capital markets. Moreover, supervision of compliance with existing rules in this area is extremely difficult to achieve in the current conditions. In other words, we can say that a global financial system, where hundreds of billions of dollars can move simultaneously in response to the latest news and possibly only on the basis of physiological factors, is a system characterized by a reduced stability.

It is clear that speculative movements represent a harmful source, threatening the stability of financial markets. It is known, in this respect, George Soros' intervention in September 1992, who, speculating on a devaluation of the sterling pound, sold (on time) pounds worth of 10 billion dollars, contributing to a substantial fall in the pound and its withdrawal from the European Monetary System [Cohen, 2004, 15]. In this case it was also important the fact that George Soros drove a successfull investment fund, with assets of over 110 billion dollars. Thus, the statement - "I expect that the most important currencies to decline" - made in „The Times” after it had already taken a position, speculating on the German mark, had a major contribution to the devaluation of the pound. This episode demonstrates that the mere statement of some influential people are more than enough to create instability in international interconnected financial markets. Another well known example, which shows potential source of instability generated by globalization is that of Barings Bank, when an agent of the subsidiary companies of Barrings Bank, in Singapore was able to speculate, in less than a month, 29 billion dollars on Japanese derivative markets, causing the bank a loss of 1.3 billion dollars, which resulted in the bank's bankruptcy[70] [Heteş, 2009, 111].

The gravity of the situation is also suggested by some studies, that consider that the governors of central banks around the world, in the case of a hypothetical agreement, could not mobilize in a day more than 14 billion dollars, insignificant amount compared to the hundreds of billions circulating every day in the forex market. As an example, a conjugated substantial effort, of the the FED and other 16 central banks, in a single day (24 June 1994), in order to halt the depreciation of U.S. dollar, through its concentrated buying, that has resulted in the performance of actually buying an amount of about 5 billion dollars, was barely noticed in the market [Hirst, 2002, 47].

## 2.3 Institutional globalization

Besides information asymmetry and speculative operations, the institutional globalization also has an important contribution to increased risk and volatility of global financial environmen. At a first glance, the growing cross-border links at

[70] An old institution of over 233 years, Barings Bank suffered a loss of 1.3 billion dollars in February 1995 as a result of transactions carried out by its subsidiary in Singapore. The loss was greater than the mass of available capital plus reserves, the bank being forced to declare bankruptcy. Subsequently, it was taken over by ING Bank, for the symbolic sum of 1 pound and a commitment to substantially cover the debt.

institutional level induce some benefits in terms of stability, development and efficiency of the financial sector, in terms of lower volatility of revenue and value of assets, as a result of reduced exposure to originare market conditions, better risk management practices and the orrientation of capital to the best winning opportunities, higher profitability of foreign operations due to the use of more sophisticated techniques and products, a greater stability of credit availability, linked to the distance of the parent banks from the cycle of domestic credit in any particular country, increased access to deeper international markets, for funds' procurement, greater liquidity for investments and increased access to risk guarding tools.

Beyond these positive implications, there are, also, a number of issues that should not be ignored. Thus, parent institutions can develop in a manner in which they can waste capital or to lose focus on the home market, in terms of capital market expectations (if banking products and techniques are not transferred in an appropriate manner, or if the host markets or management strategies are not sufficiently adapted to the conditions there). On the other hand, risk management in a large financial group, operating in a large number of cultures and time zones, will inevitably face much more difficulties than if operating in the the structure of a single country, in spite continuous innovation in the field. Here is a case of ensuring a proper management of operational risk and market operations outside of the parent companies[71]. Regarding credit risk management, difficulties may occur in the case of limited or inconsistent information regarding the conduct of credit relations in the host country, thus reducing the effectiveness of measurement instruments and risk management system as a whole [Heteş, 2009, 112].

In this context, there remains open the question on positive reaction or not of the market to cross-border activity of financial institutions and on the way in which it leads to a decline in risk related to institutions as a group. As all banks and most of them extend their activity beyond national borders, they may become more vulnerable to large shocks and to the contagion effect. Thus, the large volume of transactions, the links established between major financial conglomerates, the relatively small number of international players that play a central role in key markets, increase the risk at both individual financial systems level and international level. A sound example is the process of European integration, which has not generated a positive, unambigous effect on financial stability[72].

Another important aspect concerns the prospects for financial stability in emerging countries, as host countries. Developments in the last period shows that

[71] Fraud and management deficiencies may occur in domestic firms, but the control procedures and the application of penalties, are more difficult to implement in transnational structures. The cases of Barings bank and Allied Irish Bank best illustrate this situation.

[72] For a selected group of major European financial institutions, it has been demonstrated that during 1990 and 2007 the risk has decreased, while the degree of sensitivity to real and financial shocks, both in banking and insurance has increased in most countries [Decressin, 2008, 32].

the presence of foreign banks on strong markets in developing countries has, generally, led to a greater robustness of their financial systems in the face of traditional banking crises. For example, most banks in the countries of Central and Eastern Europe are owned by large European banks with strong capital bases and a substantial presence in the region, the parent banks being able to ensure effective supervision of operations of subsidiaries abroad, as well as financial support if needed, which contributes to increased stability of the financial system as a whole [Kaufman, 2003, 12]. On the other hand, however, the scale at which the most transactions are carried out and the changing nature of foreign holdings in host countries, generates new challenges for authorities. Foreign banks have become major channels for transmitting different types of vulnerabilities, and therefore, the financial systems, characterized by a substantial foreign presence, even if less vulnerable to shocks occurring at the local level, prove to be more vulnerable to external shoks that seriously affecting the parent bank.

## 3. SYSTEMIC RISK AND GLOBALIZATION

Risk and high volatility of global financial markets, associated with the extrapolation of different categories of distortions (information asymmetry, speculative operations, the work of institutional investors), and hence the financial vulnerability creates a framework for the emergence and spread of global turmoil, their defining aspect relating to the overheating of problems of financial management, due to the complex process of globalization. In this context, even if for a long time the concept of systemic risk has been circulating only in the national context, gradually the need appeared for imposing a new concept, that of overall systemic risk.

The significance of the concept of systemic risk, seen in a general manner, is somehow ambiguous, in the literature this being explained in several ways. Kaufman identified systemic risk with a massive macroshock producing large adverse effects, almoust simultaneously, at the level of a large part or even at the level of the whole economy or system. In this case, the term refers to systemic events that affect the entire banking system, financial, or economic system and, not only a single institution [Kaufman, 2003, 14]. Mishkin defines systemic risk as the probability of occurrence of a sudden and unexpected event, which negatively affects the information in the financial markets, making them unable to alocate funds to the most productive investment opportunities [Mishkin 1998, 11].

Defining systemic risk as the risk of a chain reaction of the fall in interconnected dominoes is consistent with the definition of the Federal Reserve System. In payment systems, systemic risk can occur when an institution participating in a system of large settlements, can not or does not wish to liquidate its net debtor position. If facing such a situation, the institution's creditors,

participants in the system, might not be able to liquidate their commitments themselves. Hence severe effects may reverberate on other participants from private networks and on non-financial institutions in general [Kaufman, 2003, 8]. The Bank for International Settlements defines systemic risk in a similar way, namely, the risk of not fulfilling commitments by a participant in the system to cause an payment incapacity of others, such a chain reaction leading to more general financial difficulties [BIS, 1994 21].

Reported to all these points of view presented in a synthetic manner, systemic risk presents a certain domino effect, so when a piece falls and knocks others down as well, thus causes a chain reaction which can be quite difficult to stop and costs quite high[73]. This can best be highlighted in the banking system. Banks in a country tend to be interconnected through interbank deposits and loans. Bankruptcy of a bank may trigger a serious reaction in the chain, so that, in the absence of an adequate capital ratio, together with a high degree of indebtedness, increases the probability of insolvency as a cause of the insolvency of banks located "earlier" on the transmission chain and thus propagating to banks located "later" on this chain [Cohen, 2004, 15]. The speed of propagation of shocks to the financial sector, along with the probability that it affects both solvent companies, as well as insolvent ones, as well as the incapacity to protect against its destructive effects, makes it necessary for systemic risk to be treated with greater caution.

Regarding the concept of global systemic risk, it appears as an extreme manifestation of the global financial instability, a macroshock which affects the world economy as a whole. Globally, modern financial markets operate in such a way that they enable institutions to protect against specific risks, such as fluctuations in exchange rates or interest rates. However, they only transform and redistribute risk instead of eliminating or reducing it for the whole system. Moreover, cross-border financial flows and interconnection of national financial markets allow faster transmission of shock waves.

Consequences of a domino effect or generalized contagion can be disastrous to the extent that financial difficulties encountered by one or more institutions in a country can have major indirect effects on the rest of the global financial sector. The term “hot money" is relevant to what happens when there is a panic in the financial market. Portfolio investment, the most sensitive and at the same time, the the most liquid, can be withdrawn immediately and shifted to other areas deemed safer.

Currently, high risk, along with the potentially volatile nature of global financial markets and instant dissemination of information between the financial centers of the world, make the overall systemic risk a greater threat to international

[73] The Bank of England Governor’s has described this effect as reverberating to the financial exposures by linking businesses like mountain climbers link each other when they escaladate a mountain, so if one falls on the rocks, also pulls the others down.

finance. No government alone can solve it and neither can it isolate its economy form this threat.

## 4. Financial crises as form of instability

Financial instability describes a situation of price volatility of financial assets, a situation that may entail some costs. In the absence of appropriate remedial measures, it may even lead to bankruptcy of several financial institutions, infrastructure problems in the financial system and ultimately affect all financial markets, which, through the effect of contagion could spread worldwide, thus risking of destabilizing the global financial system and economy.

A financial crisis can be regarded as a severe form of instability, representing a situation where, after an episode of instability, the system does not return to the normal state, just by simple remedial measures. Thus, there are required more extensive and more severe masures, which will restore discipline in the financial markets, sometimes accompanied by the restructuring of the system [Laeven, 2008, 3].

The term financial crisis is applied to a variety of situations in which many financial institutions or financial assets suddenly lose a large part of their value. Depending on how defined, there are various ways in which financial crises can be classified. Other cases bearing the name of the financial crisis include crahs of the stock exchanges and the emergence of new types of speculative bubbles, as well as phenomena like currency or debt crisis [Allen, 2005, 4].

In the light of their effects, financial crises have led affected economies into deep recessions and caused sudden inversions in the current account. Some of these phenomena were marked by contagion, rapidly propagating to countries that had not experienced vulnerabilities in the financial sector. Among the many causes of financial crisis we can find a combination of unsustainable macroeconomic policies, credit expansion, massive inputs of capital and fragile balance sheet, combined with a variety of economic and political constraints [Reinhart, 2008, 7].

In time various parts of the world were at one time affected by the crisis. Figure 9 presents the number of crisis, according to their type from 1880 to 1913, and Figure 10 compares the frequency of crises in two periods: 1880-1913 and 1980-2004.

**Figure 9** *The incidence of different types of crises in the period 1880 – 1915*

**Source**: [Bordo,2006,8]

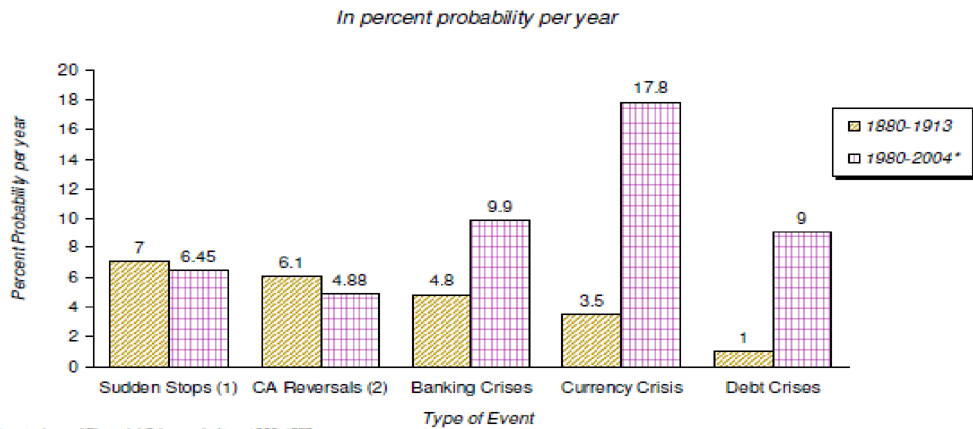


**Figure 10** *Crisis frequency 1880-2004*

**Source**: [Bordo,2006, 9]

Thus, one can see a reversal in the probability of occurrence of different types of financial crises: if during the 1880-1913 crisis of sudden stops (sudden and drastic decline of capital flows) and CA Reversals (adjusted current account) presented a greater probability of occurrence, in the period 1980-2004 the situation was reversed, banking crises, monetary and debt beeing more common [Freund, 2000, 21].

Since the 90s, the simultaneous occurence of a large number of banking, currency and capital market crisis resulted in defining a new notion, namely the twin crises (twin crises). Kaminsky and Reinhart emphasized that financial liberalization in the 80s has led to the occurrence of twin crises. They stressed that fact that, in 1970, when financial systems were strictly regulated in most countries, currency

crises were not accompanied by banking crises. The sequence of events in these cases is from currency crises to banking crises, as was the case of the Asian crisis [Allen, 1996, 11].

Corsetti has developed a model a model of twin crises meant to explain the Asian crisis. It detected as a trigger, the moral hazard induced by government guarantees. Foreigners are willing to grant loans to finance unprofitable projects because of security provided by the state aid in case of default. When the profits made by these projects prove to be low, banking crises occur. Forecasts regarding the use by the government of its sovereignty for aid increases inflation expectations and furthermore to currency to dpereciation [Allen, 1996, 14].

The succession of financial crises of the 90s began in Mexico and Turkey in 1994, then in Asia in 1997 and in Russia in 1998, rapidly propagating to other emerging countries and, making it necessary the reformation of the financial system architecture. Even if the crisis initialy affected only the developing countries, their presence could also be encountered, although in a less serious form, in developed countries as well, an example being in this way beeing the European Monetary System Crisis of 1992, or the repercussions suffered of Japan.

In the case of Mexican crisis, the determinant factors were not those of social and political instability[74] nor the poor economic management, but rather the inability to control the portfolio investment flows together with a potentially high risk due to openness of the Mexican economy since 1989 to foreign portfolio investments [Grabel, 1998, 18]. In 1989, Mexico was considered to be one of the most dynamic emerging markets. Investor interest in the area was supported by government initiatives to political democracy and economic liberalization measures that have received immediate attention from the U.S. Also, the signing of the NAFTA[75], has created new investment opportunities in the area, giving them implicit U.S. guarantee for the investments made[76].

Turkey started to implement reforms of liberalization, since the 80s. At the end of the 80s, worsening economic conditions, led the Turkish government to consider a mechanism to overcome the recession, based on massive inputs of foreign capital, without, however, giving importance to structural deficiencies from which which the economy suffered. The last stage of capital account liberalization and the transition to full convertibility of the Turkish pound in 1989 increased in a

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[74] This, however, characterized the earlier outbreak and Mexico during the crisis

[75] North American Free Trade Agreement

[76] High yields offered by the Mexican government bonds in the short term, have also been particularly attractive for both private and institutional investors. Both short-term dollar and peso denominated bonds, gave yields that exceed the ones available elsewhere, especially in the U.S., where the low 1993 interest rates encouraged investors to exit the country. Attracted by the higher yields in 1990 portfolio investments began to focus heavily on the Mexican financial markets. During this period in which the inputs of private capital flows have increased, the peso was fixed by the government to an overvalued level.

uncontrollable manner the inputs of capital from the outside. They have created a pressure on the exchange rate appreciation in real terms, which in turn has reduced exports and encouraged imports. In this context, inputs of funds were used to offset the current account deficit between 1989 and 1994. In fact, the lack of restrictions on public spending, as they could be financed through internal and external debt, has led to an increase in government deficit.

At the end of 1993, it became clear that the apparent increase in the Turkish economy was not based on solid foundations. All promoted policies, combined with the reduction of Turkey's rating by two international rating agencies, have precipitated the 1994 crisis, evidenced by a strong withdrawal of capital in the short term.

With regard to episodes of crisis in Southeast Asia, most authors argue that countries in the region were vulnerable to a financial crisis due to enhanced growth of capital flows, weak macroeconomic policies, as well as due to weak financial institutions and companies. The link between the balance of payments and financial crises is therefore very close, but this is already known and has been studied on several occasions by various economists [Reinhart, 2008, 15). Kaufman emphasizes the link between banking crises and currency crises. The economies of Southeast Asia were called "Asian miracle" due to rapid industrialization, strong growth in GDP and exports in the 80s and 90s [Kaufman, 2000, 23]. Given the success of the respective economies, analysts have categorized them as model worth to be followed by other economies in developing countries that were facing problems.

Until 1997, Asia attracted almost half of the capital flows directed to the developing countries. Countries of Southeast Asia particullarly maintained high interest rates, attractive for foreign investors who were in search of higher yields. As a result, the economies in the region have attracted significant flows of money, with dramatic increases in asset prices. Meanwhile, in the 80s-90s, Thailand, Malaysia, Indonesia, Singapore and South Korea recorded economic growth of 8-12% of GDP. These performances have been regarded, even by international financial institutions, as part of the "Asian economic miracle."

Not all economists have agreed with the "Asian miracle". Krugman attacked the idea, arguing that the economic growth of countries in Southeast Asia was the result of capital investment, which only increased the marginal productivity of the production factors, and not the overall productivity. He claimed that a total productivity growth can lead to long-term prosperity [Radelet, 1998, 17]. From 1985 to 1996 the Thai economy grew by an average of over 9% per year, registering the highest rate of growth of the time. Speculative booms have characterized in Thailand since 1992, on the background of increases in equity and real estate and prices, as well as a growth in the commercial construction business. As in other parts of the region, the capital market was invaded by flows of foreign portfolio investments.

Foreign investors were attracted by the high yields offered by Thai markets as a result of the 1990 deregulation.

The crisis began in Thailand, with the Thai baht collapse[77]. At that time, Thailand had a large foreign debt that has actually led to bankruptcy of the country, even before the currency's collapse. While the crisis was spreding in most south-eastern asian countries and Japan, a sudden depreciation of national currencies took place, along with a devaluation in capital markets and asset prices as well as a sudden increase in private debt. Sothere followed a massive withdrawal of investors from the Thai market.

In the fall of 1997, signs of the Asian flu began to make their appearance in Brazil as well. As investors left the market in Hong Kong, a simmiolar exit was encountered in the Brazilian market, together with the liquidation of investments in national currency. Stock exchange index in Brazil fell by 8% on 23 October 1997, followed by a further dramatic fall five days later. In the three weeks after investors' exit in Hong Kong, the capital market in Brazil has lost 40% of its value. Central Bank of Brazil tried to temperate capital outflows by doubling official interest rate to 40%, and by mobilizing 8 billion in foreign reserves to protect the national currency [Cohen, 2004, 16].

At the end of October 1997 investor withdrawal began in the Russian market as well, at the same time with withdrawals from other markets like Brazil, Hong Kong and Southeast Asia. Stock Exchange index continued to fall in early December. Due to severe market decline, the president of that time, Boris Yeltin stopped trading for several hours, trying to stabilize Russian Ruble by buying it on the open market. Also, the government has increased the interest rates on state bonds to 28% in an effort to prevent capital outflows and attract new foreign capital. Increased interest rates have imposed additional pressures on the state budget already scarce.

Looking back at the episodes of crisis in the 90s that have affected developing countries, in my view the main common feature is the fact that, to a greater or lesser degree, they took place in a period characterized by a sudden internal process of financial liberalization. All countries affected by the crisis tried to benefit as much as they could from the opportunities offered by international financial markets and, based on the neoliberal reforms promoted globally, they acted towards liberalizing their capital account.

Access to cheaper resources allowed them to accelerate the rate of economic growth and therefore become extremely sought for. Foreign funds that developing countries have managed to attract, at a first glance appeared to target different sectors of the economy, but in reality, most of them were concentrated in less

[77] This was caused by the decision of the Government Thai to install the baht flotation, following major efforts to sustain it in face of financial extentions, caused by factors in the housing market.

productive areas, in the way that the profits obtained were smaller than the cost of capital. Figure 11 presents the drastic increase in private capital flows to emerging countries.

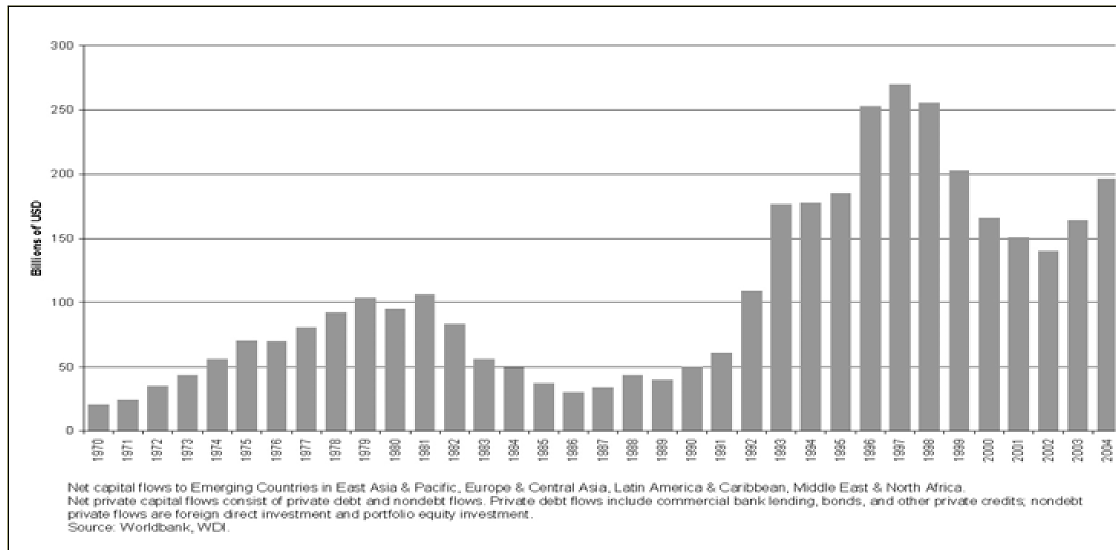


**Figure 11** *Real private capital flows to emerging countries*

**Sursa:** [Bordo,2006,4]

Another feature common to the countries affected by the crisis is the fact that, when they acted in the direction of liberalization, they gave little importance to the scale of regulatory reform, which led to a weak regulation and supervision system. The attention was focused exclusively on the mechanism of the market, without considering the management problems that may be generated by the sudden opening of the capital account.

Since the 80s, the expansion of credit has characterized many of the developing countries, the trend being more pronounced in the case of the Southeast Asia crisis (banks and firms could easily access the international capital market). This development was due to the favorable situation, because of the missing role of supervision, regulation and discipline. Opportunities for easy access to foreign funds turned into a typical problem of moral hazard. Banks have continued to increase theyr loan portfolio, without taking into account any prudential limits, based on the fact that economies are sufficiently strong to prevent a crisis as well as widespread bankruptcies.

A similar situation existed in the case of Mexican crisis. The government in this country was exposed to a large volume of debt and channeled funds to the private sector through an increase in bank loans. The problem of moral hazard can be identified in the relaxation of credit conditions, which has stimulated a consumption boom and discouraged domestic savings process. As regards Turkey, even if part of the capital inflows was orientated to credit expansion in the period

before the crisis, most were intended to cover the budget deficit increases, due to pressures in income distribution in the reform and restructuring process.

The exchange rate, correlated with extreme capital account liberalization, has played, certainly an important role in all crises. Increased flows of foreign capital have boosted the demand for currency, which led to a considerable discretion, which combined with government policy typically of fixed exchange rates against the U.S. dollar, further reduced competitiveness and slowed down exports[78]. In addition, the implementation of the capital account liberalization has been unable to control the supply of currency in the countries affected by crisis. Given that, the capital inflows have not contributed to an increase in productivity this resulted in inflationary pressures. In response, governments focused on controlling inflation and adopted a policy of stable exchange rates, which emphasized the tendency of overvaluation. This trend has rapidly become unsustainable because those countries did not have sufficient foreign reserves to finance the trade deficit, which grew rapidly.

In a synthetic manner, the aspects that have characterized the crises in developing countries in the 90s can be grouped as follows:

**Table 9** *Financial crises in the 90s in developing countries: common features*

| | |
|---|---|
| • | Inadequate financial liberalization and high short term capital inflows |
| • | National currency appreciation and current account deficits |
| • | Errors in borrowd funds' use in a weak regulation framework |

**Source**: the author

Despite the given common elements, the crises also present differences regarding: the magnitude, the degree of integration of the countries concerned on the international financial market, economic fundamentals that characterized the size and destination of foreign capital flows. If we consider the degree of integration into the world economy, the Asian countries, seen as a group, were more active on international markets, compared to Turkey, Russia or countries in Latin America. This is supported by indicators related to trade and share of exports / imports to GDP, as well as greater flows of capital they have managed to attract. This integration was equivalent to greater sensitivity to changes in external economic environment, as evidenced by the fact that the crisis in Southeast Asia was the largest after the great depression of the 30s.

As regards the macroeconomic fundamentals of the key deficiencies, these were less visible in the South Asia region, compared to other countries affected by crisis. These countries had acceptable rates of inflation and budget surpluses, and if there were deficits they were very small. An important role in the emergence and spread of the crisis has been played by the speculative or panic attacks, which was, relatively, surprising for those who have reported to the healthy fundamentals.

[78] from 1987 the U.S. dollar started appreciating

Going further, the funds' inflows, which in all cases were short term, in Asian region they have been concentrated, especially in the private sector, unlike the countries of Latin America, Turkey and Russia, where most of the debt has been drawn by the government. In the'80s, the mirage of the international capital market has attracted many Latin American countries, governments here contracting a large volume of euroloans often intended to finance unprofitable investment projects. In Turkey and Russia, big budget debt led to a massive increase in domestic and foreign loans. The funds obtained were used to cover the budget deficit and the countries concerned should have been aware that in order to pay this debt, they should be able in the near future to obtain a surplus.

Mexico situation is slightly different, because it was able to sustain a budget surplus after 1992, but the entries of foreign capital have not been much better used because they were directed to a consumption boom, without taking into account that the rate of profit of the used capital should be greater than its cost, in order for flows to be sustainable. As regards South-East Asia have, here there have been preferred financial investments and speculations in the real estate. The result was the creation of a vicious circle of unproductive and speculative investment, rising inflation, exchange rate appreciation and export decline rate, factors that have made countries more vulnerable to financial crises. As a concept, all countries that have received entries of foreign funds, higher or lower, although they have used these in different ways, however, giving little attention to the adverse effects they have generated.

**Table 10** *Financial crises of the 90s in development countries: diferences*

| | **Mexico** | **Turkey** | **South-East Asia** | **Russia** | **Brazil** |
|---|---|---|---|---|---|
| **The degree of integration in the world economy** | Moderate | Reduced | Big | Reduced | Moderate |
| **The amplitude of the crisi** | Medium importance crisis | Minor crisis | Major crisis | Medium importance crisis | Minor crisis |
| **Capital flows' dimension** | Big speculative short term capital flows: the FDI represented 1/5 of the total fund inflows | Reduced flows of short term external funds, in the form of bank loans | Big speculative short term capital flows: Portfolio investments an d bank loans | Big speculative short term capital flows in the form of bank loans; certain level of FDIs | Reduced flows of short term external funds, in the form of loans |
| **Main borrowers** | Government and private agents | Government | Private sector | Government and private agents | Government |
| **Macroeconomic fundamentals** | Modest | Weak | Apparently strong | Weak | Modest |

**Source**: the author

## 5. CONCLUSIONS

Currently, globalization tends to dominate the contemporary world, imprinting, to a lesser or greater extent, all the details of life: at economic, political and cultural level. The financial environment has undergone a profound transformation in the context of globalization, financial flows of scale, the complexity and speed of transactions, as well as the diversification of financial instruments, being of critical importance. Financial markets are increasingly interdependent, and in this regard, the financial conditions of a region have an almost immediate impact on the national financial markets across the globe.

The size of the international capital markets has increased remarkably, as a result of market liberalization and growth of investment opportunities. Regarding the participation at the international financial flows, this does not remain restricted only to the economically developed countries, but has also focused to the emerging and developing countries, but these transactions being largely concentrated. One can therefore say that the developing or emerging countries are ncluded in the global financial system, but in an extremely hierarchical and scratchy manner.

Seen in its essence, financial globalization is a complex process, with contradictory results and developments. Explosive development of financial activities and the complexity of the global financial markets have transformed the management of developed economies. This growth offers significant opportunities for governments and corporations to enter new markets and enables investors to obtain the best performance worldwide.

The development of more extensive and liquid capital markets, along with the increased competition and the use of new and more efficient technologies, leading to reduced transaction costs, an increased efficiency in the allocation of capital and easier access to external financing, also leads to increased production potential in the world. However, while global financial markets play a crucial role in the distribution of global capital, they do so in a way that can have profound negative implications, entailing certain risks and costs.

As demonstrated by the analyzed crisis episodes, globalization is capable of causing instability in the whole world, also enabling broad crises, and, not least, increasing the danger of recession in the world, based on the manifestation of the global systemic risk. Most affected in this context are the developing countries. Figure 12 tries to capture an overview on how globalization is contributing to increased financial vulnerability, to the emergence and development of episodes of crisis, both through national and international mechanisms.

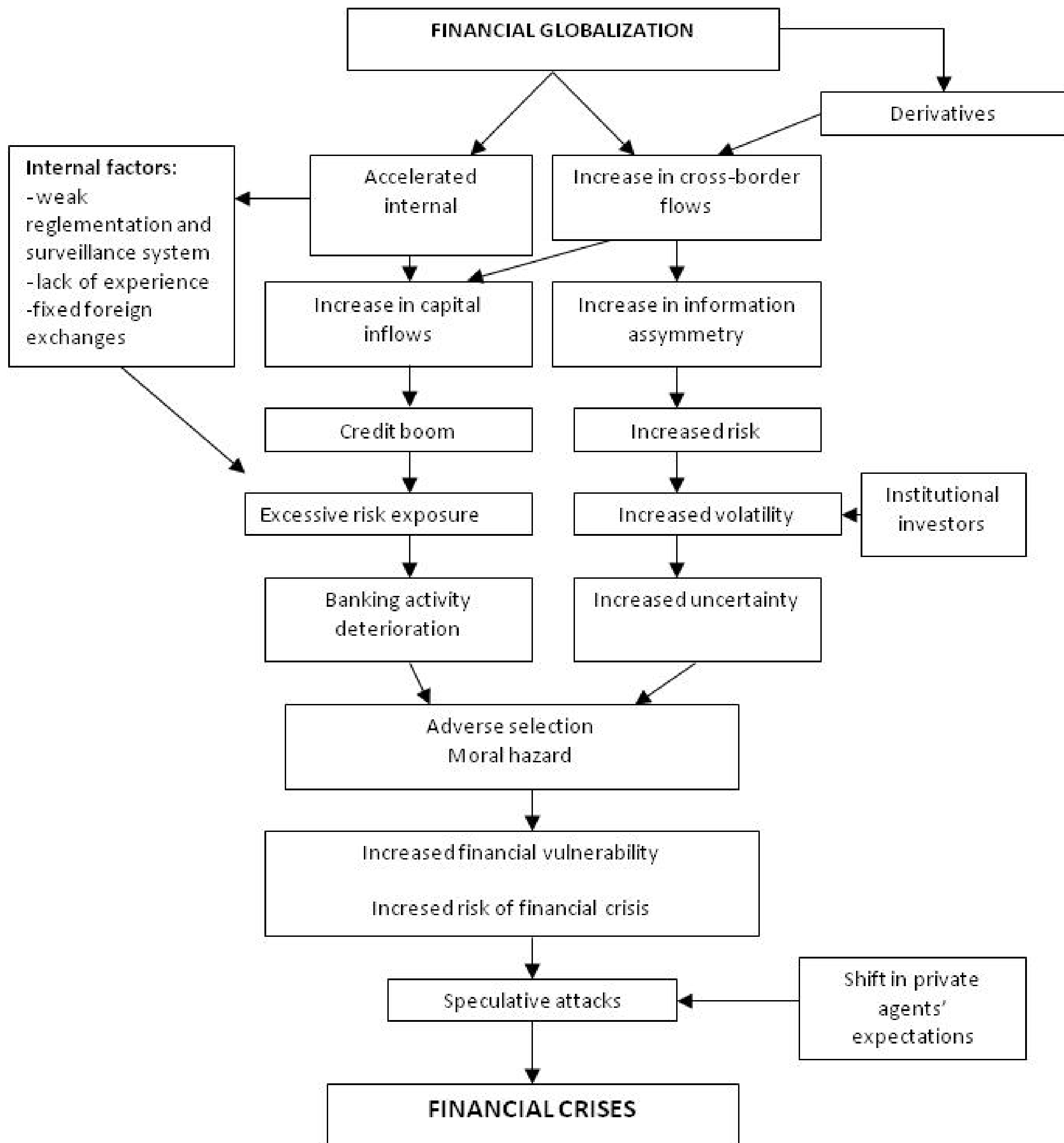


**Figure 12** *The relationship globalization – financial crises*

Despite the differences that occur in each case, current account liberalization, in an incompletely regulated and the intrinsic instability of the global financial markets, are the main reasons of the outbreak of crisis in the 90s in the developing countries. We can say that financial liberalization was the result of two phenomena. On the one hand, the countries considered, for many reasons (the desire to increase competition in the financial sector in order to reduce interest on loans, participation in international organizations and agreements) that the process of liberalization as necessary to be adopted by their economies, and therefore we can say that it was due, in part, to internal factors.

On the other hand, financial openness of developing countries followed the normal pattern of the general process of globalization, which began to develop and

characterize the international economic system after the collapse of Bretton-Woods and has made possible for cross-border financial flows. After the financial liberalization process involving OECD member countries, from the mid 70s, the volume of funds in search of opportunities and higher earnings increased continuously. In this context, capital flows from developed countries targeted the least developed countries, particularly those in Latin America and Asia[79].

Another aspect to be taken into account is the increasing volatility induced by globalization. Volatility may be related to increased uncertainty by increasing information asymmetry. Thus, investors know more about national markets, compared with foreign markets, and therefore there is an increased uncertainty in cross-border transactions. Increased information asymmetry along with a large volume of cross-border funds has favourde short term capital inputs, denominated in national currencies, which indirectly led to excessive risk.

Without denying that the difficult economic situation in countries affected by crisis, is living proof of the fact that the international financial markets can have disastrous effects on national economies, it cannot be ignored the fact that imprudent policies have played a role in the process through which these economies have come to be very vulnerable to sudden changes in financial flows. If big countries, with extensive resources and markets, can long resist the economic forces, this happens very rarely in small countries, especially in those promoting imprudent policies[80]. Inadequate management, a weak regulatory system, reduced cost of loans (financial openness has facilitated access to funds with interest rates lower) and the fixed exchange rates (foreign exchange risk was lower priced) are the main internal factors that contributed to increasing risk.

But taking into account all the variables in the equation, I believe that the successive crises of the 90s (Turkey, Mexico, Southeast Asia, Russia, Brazil) may be considered, rightly crisis of globalization. Even if all the affected economies had weaknesses and were vulnerable to sudden changes in the economic situation, premature liberalization and massive inputs of funds, associated with globalization, have exacerbated what could have proven to be a simple and limited financial crisis. The economic instability incumbed by international financial crises along with the fact that they ultimately hit the population, prove, more than ever, the need for appropriate measures ofcrisis management and, both at national and international level.

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[79] This trend supports the assertion that developing countries are included in the financial system globally, but in an extremely hierarchical and scratchy manner.

[80] USA, for example, had for 30 years and a trade deficit, however, there has not been any serious threat.

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