1 GLOBAL FINANCIAL SYSTEMS

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LEARNING OBJECTIVE

After studying this chapter, you should be able to:

- Understand Flows within Global Economic System
- Understand Types of Markets
- Understand International Monetary Systems
- Describe Globalization
- Analyze Risk of Globalization

KEY TERMS

This chapter features these terms which you should strive to do more research about:

Global Economic	System	Open Markets
Money Market	Capital Market	Negotiated Markets
Spot Market	Future & Option Markets	Neo-Marxists
Gold Standard	Bretton Woods System	Floating Exchange Rate
Fixed Exchange Rate	Globalization	

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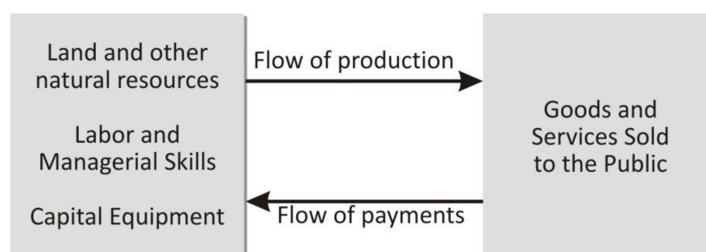
FINANCIAL SYSTEM

The financial system is the collection of markets, institutions, laws, regulations, and techniques through which bonds, stocks, and other securities are traded, interest rates are determined, and financial services are produced and delivered around the world.

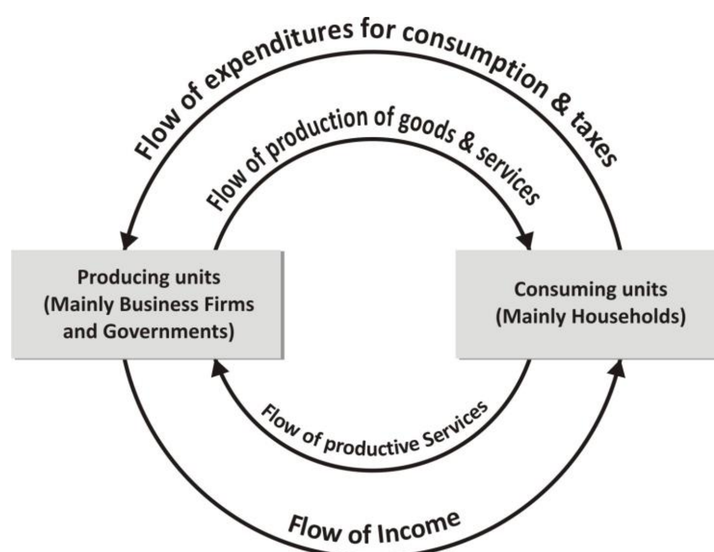
The primary task of the financial system is to move scarce loan able funds from those who save to those who borrow to buy goods and services and to make investments in new equipment and facilities, so that the global economy can grow and the standard of living can increase.

FLOWS WITHIN THE GLOBAL ECONOMIC SYSTEM

- The basic function of the economic system is to allocate scarce resources – land, labor, management skill, and capital – to produce the goods and services needed by society.
- The global economy generates **a flow of production** in return for a **flow of payments**.
- The circular flow of production and income is interdependent and never ending.



FLOWS IN GLOBAL ECONOMY



FLOWS WITHIN AN ECONOMIC SYSTEM

The Role of Markets in the Global Economic System

- In most economies around the world, markets carry out the complex task of allocating **resources and producing goods and services**.
- The marketplace determines what goods and services will be produced and in what quantities through their **prices**.
- Markets also **distribute income** by rewarding superior producers with increased **profits**, higher **wages**, and other **economic** benefits

TYPES OF MARKETS

There are essentially three types of markets within the global economic system.

- The **factor markets** allocate the factors of production to the owners of productive resources.

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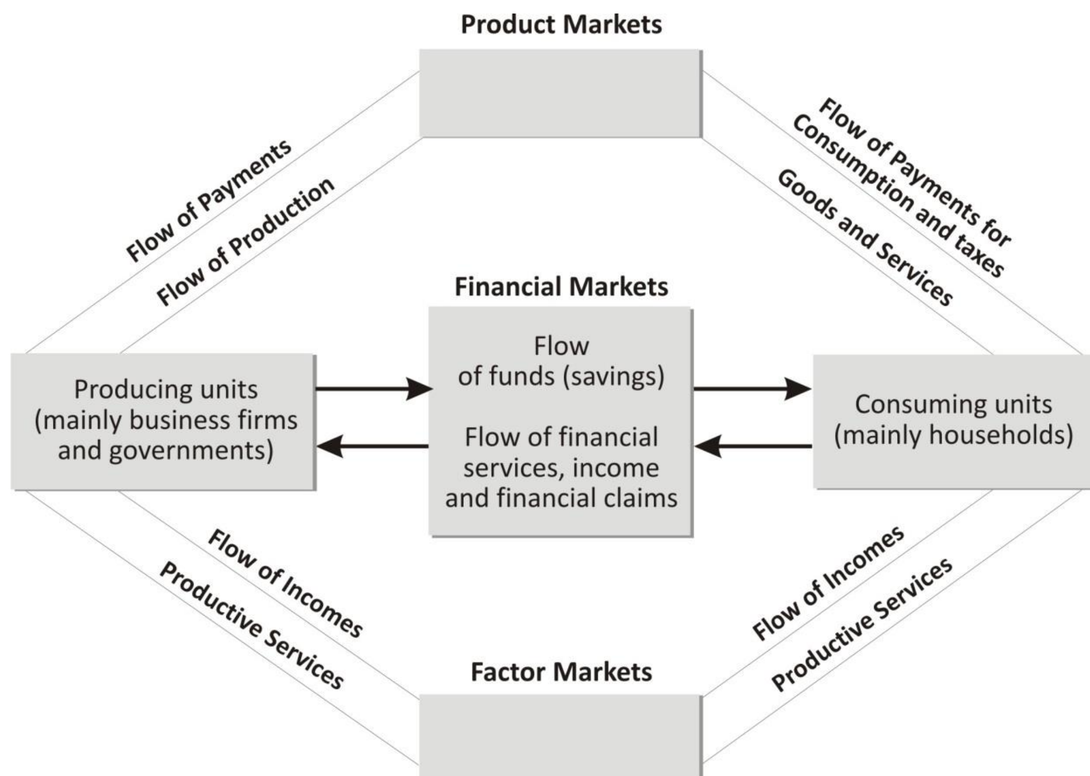
- **Consuming units** use most of their income from factor markets to purchase goods and services in product markets.
- The **financial markets** channel savings to those individuals and institutions needing more funds for spending than are provided by their current incomes.



RELATIONSHIP BETWEEN DIFFERENT MARKETS

Factor Markets: A market used to exchange the services of a factor of production i.e. labor, capital, land, and entrepreneurship. Factor markets, also termed resource markets, exchange the services of factors. Capital and Land are two resources than can be and are legally exchanged through product markets. The services of these resources, however, are exchanged through factor markets. The value of the services exchanged through factor markets each year is measured as national income.

Firms buy productive resources in return for making factor payments at factor prices. The interaction between product and factor markets involves the principle of derived demand. Derived demand refers to the demand for productive resources, which is derived from the demand for final goods and services or output.

For example, if consumers demand for new cars rises, producers will respond by increasing their demand for the productive inputs or resources used to produce new cars.

Product Market is a mechanism that allows people to easily buy and sell products. Services are often included in the scope of the term.

Financial Markets: A financial market is a market in which people and entities can trade financial securities, commodities, and other fungible items of value at low transaction costs and at prices that reflect supply and demand. Securities include stocks and bonds, and commodities include precious metals or agricultural goods.

The financial markets make possible the exchange of current income for future income and the transformation of savings into investment so that production, employment, and income can grow.

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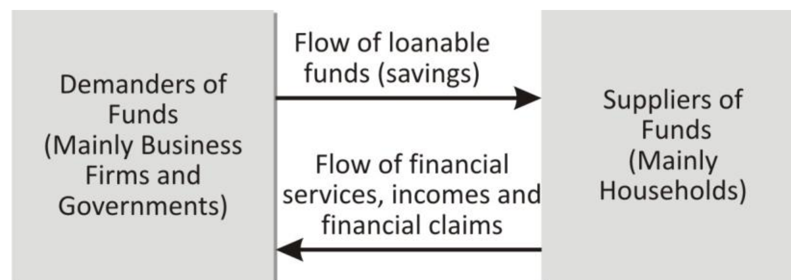
The suppliers of funds to the financial system can expect not only to recover their original funds but also to earn additional income as a reward for waiting and for assuming risk.



GLOBAL FINANCIAL SYSTEM

The Global Financial System (GFS) is the financial system consisting of institutions and regulators that act on the international level, as opposed to those that act on a national or regional level. The main players are the global institutions, such as International Monetary Fund and Bank for International Settlements, national agencies and government departments, e.g., central banks and finance ministries, private institutions acting on the global scale, e.g., banks and hedge funds, and regional institutions, e.g., the Eurozone.

Functions Performed by the Global Financial System and the Financial Markets can be Summarized as under:

- **Savings function.** The global system of financial markets and institutions provides a conduit for the public's savings.
- **Wealth function.** The financial instruments sold in the money and capital markets provide an excellent way to store wealth.
- **Liquidity function**. Financial markets provide liquidity for savers who hold financial instruments but are in need of money.
- **Credit function**. Global financial markets furnish credit to finance consumption and investment spending.
- **Payments function**. The global financial system provides a mechanism for making payments for goods and services.
- **Risk protection function**. The financial markets around the world offer businesses, consumers, and governments protection against life, health, property, and income risks.
- **Policy function**. The financial markets are a channel through which governments may attempt to stabilize the economy and avoid inflation.

Types of Financial Markets within the Global Financial System

- The **money market** is for short-term (one year or less) loans, while the capital market finances long-term investments by businesses, governments, and households.
- In particular, governments borrow from commercial banks in the money market, while in the capital market, insurance companies, mutual funds, security dealers, and pension funds supply the funds for businesses.
- In **open markets**, financial instruments are sold to the highest bidder, and they can be traded as often as is desirable before they mature.
- In **negotiated markets**, the instruments are sold to one or a few buyers under private contract.
- Financial capital is raised when newly issued securities are sold in **the primary markets**.
- Security trading in the **secondary markets** then provides liquidity for the investors.
- In the **spot market**, assets or financial services are traded for immediate delivery (usually within two business days).

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- Contracts calling for the future delivery of financial instruments are traded in the **futures or forward market.**
- Contracts granting the right to buy or sell certain securities at specified prices within a certain period are traded in the options market.

INTERNATIONAL MONETARY SYSTEMS (IMS)

IMS are sets of internationally agreed rules, conventions and suppor-ting institutions that facilitate international trade, cross border investment and generally the reallocation of capital between nation states. They provide means of payment acceptable between buyers and sellers of different nationality, including deferred payment. To operate successfully, they need to inspire confidence, to provide sufficient liquidity for fluctuating levels of trade and to provide means by which global imbalances can be corrected. The systems can grow organically as the collective result of numerous individual agreements between international economic actors spread over several decades. Alternatively, they can arise from a single architectural vision as happened at Bretton Woods in 1944.

The history of financial institutions must be differentiated from economic history and history of money. In Europe, it may have started with the first commodity exchange, the Bruges Bourse in 1309 and the first financiers and banks in the 15th–17th centuries in central and Western Europe. The first global financiers the Fuggers (1487) in Germany; the first stock company in England (Russia Company 1553); the first foreign exchange market (The Royal Exchange 1566, England); the first stock exchange (the Amsterdam Stock Exchange 1602).

Milestones in the history of financial institutions are the Gold Standard (1871–1932), the founding of the International Monetary Fund (IMF) and World Bank at Bretton Woods 1944, and the abandonment of fixed exchange rates in 1973.

There are three primary approaches to viewing and understanding the global financial system:

1. The **liberal view** holds that the exchange of currencies should be determined not by state institutions but instead individual players at a market level. This view has been labeled as the Washington Consensus.
2. This view is challenged by a **social democratic front** which advocates the tempering of market mechanisms, and instituting economic safeguards in an attempt to ensure financial stability and redistribution. Examples include slowing down the rate of financial transactions, or enforcing regulations on the behavior of private firms.
3. Outside of this contention of authority and the individual, **Neo-Marxists** are highly critical of the modern financial system in that it promotes inequality between state players, particularly holding the view that the developed nations abuse the financial system to exercise control of developing countries' economies.

HISTORY OF GLOBAL FINANCIAL SYSTEM

Until the 19th century, the global monetary system was loosely linked at best, with Europe, the Americas, India and China (among others) having largely separate economies, and hence monetary systems were regional. European colonization of the America Sub continent starting with the Spanish empire, led to the integration of American and European economies and monetary systems, and European colonization of Asia led to the dominance of European currencies, notably the British pound sterling in the 19th century, succeeded by the US dollar in the 20th century. Some, such as Michael Hudson, foresee the decline of a single basis for the global monetary system, and instead the emergence of regional trade blocs, citing the emergence of the Euro as an example of this phenomenon.

The Pre -World War I Financial Order: 1870–1914: From the 1870s to the outbreak of World War I in 1914, the world benefited from a well- integrated financial order,

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sometimes known as the First age of Globalization. Money unions were operating which effectively allowed members to accept each-others currency as legal tender including the Latin Monetary Union (Belgium, Italy, Switzerland, France) and Scandinavian monetary union (Denmark, Norway and Sweden). In the absence of shared membership of a union, transactions were facilitated by widespread participation in the **gold standard**, by both independent nations and their colonies. Great Britain was at the time the world's pre-eminent financial, imperial, and industrial power, ruling more of the world and exporting more capital as a percentage of her national income than any other creditor nation has since.

Gold Standard: The gold standard is a monetary system in which the standard economic unit of account is a fixed weight of gold. There are distinct kinds of gold standard. First, the gold specie standard is a system in which the monetary unit is associated with circulating gold coins, or with the unit of value defined in terms of one particular circulating gold coin in conjunction with subsidiary coinage made from a lesser valuable metal.

Similarly, the gold exchange standard typically involves the circulation of only coins made of silver or other metals, but where the authorities guarantee a fixed exchange rate with another country that is on the gold standard. This creates a de facto gold standard, in that the value of the silver coins has a fixed external value in terms of gold that is independent of the inherent silver value. Finally, the gold bullion standard is a system in which gold coins do not circulate, but in which the authorities have agreed to sell gold bullion on demand at a fixed price in exchange for the circulating currency.

Gold certificates were used as paper currency in the United States from 1882 to 1933. These certificates were freely convertible into gold coins.

No country currently uses the gold standard as the basis of their monetary system, although several hold substantial gold reserves.

Towards the end of the 19th century, some of the remaining silver standard countries began to peg their silver coin units to the gold standards of the United Kingdom or the USA. In 1898, British India pegged the silver rupee to the pound sterling at a fixed rate. While in 1906, the Straits Settlements adopted a gold exchange standard against the pound sterling with the silver Straits dollar being fixed at 2s = 4d.

At the turn of the century, the Philippines pegged the silver Peso/dollar to the US dollar at 50 cents. A similar pegging at 50 cents occurred at around the same time with the silver Peso of Mexico and the silver Yen of Japan. When Siam adopted a gold exchange standard in 1908, this left only China and Hong Kong on the silver standard.

Adopting the gold standard many European nations changed the name of their currency from Rixdaler (Sweden and Denmark) or Gulden (Austria-Hungary) to Crown, since the former ones were traditionally associated with silver coins and the latter with gold coins.

Impact of World War I (1914–25): Governments faced with the need to fund high levels of expenditure, but with limited sources of tax revenue, suspended convertibility of currency into gold on a number of occasions in the 19th century. The British government suspended convertibility (that is to say, it went off the gold standard) during the Napoleonic wars and the US government during the US Civil War. In both cases, convertibility was resumed after the war.

In order to finance the costs of war, most belligerent countries went off the gold standard during the war, and suffered significant inflation. Because inflation levels varied between states, when they returned to the standard after the war at price determined by themselves (some, for example, chose to enter at pre-war prices), some countries' goods were undervalued and some overvalued.

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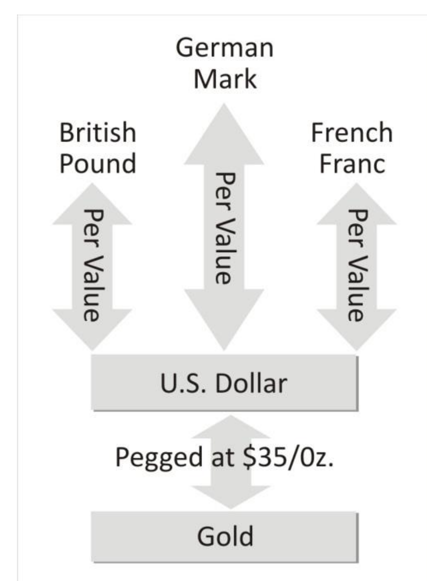
Ultimately, the system as it stood could not deal quickly enough with the large deficits and surpluses created in the balance of payments; this has previously been attributed to increasing rigidity of wages (particularly in terms of wage cuts) brought about by the advent of unionized labor, but is now more likely to be thought of as an inherent fault with the system which came to light under the pressures of war and rapid technological change. In any case, prices had not reached equilibrium by the time of the Great Depression, which served only to kill it off completely.

For example, Germany had gone off the gold standard in 1914, and could not effectively return to it as Germany had lost much of its remaining gold reserves in reparations. The German central bank issued un-backed marks virtually without limit to buy foreign currency for further reparations and to support workers during the Occupation of the Ruhr finally leading to hyperinflation in the 1920s.

Between the World Wars: 1919–1939: The years between the world wars have been described as a period of de-globalization, as both international trade and capital flows shrank compared to the period before World War I. During World War I countries had abandoned the gold standard and, except for the United States, returned to it only briefly. By the early 30's the prevailing order was essentially a fragmented system of floating exchange rates. In this era, the experience of Great Britain and others was that the gold standard ran counter to the need to retain domestic policy autonomy. To protect their reserves of gold countries would sometimes need to raise interest rates and generally follow a deflationary policy. The greatest need for this could arise in a downturn, just when leaders would have preferred to lower rates to encourage growth.

By the end of World War I, Great Britain was heavily indebted to the United States, allowing the USA to largely displace her as the world's number one financial power. The United States however was reluctant to assume Great Britain's leadership role, partly due to isolationist influences and a focus on domestic concerns. In contrast to Great Britain in the previous era, capital exports from the US were not counter cyclical. They expanded rapidly with the United States' economic growth in the twenties up to 1928, but then almost completely halted as the US economy began slowing in that year. As the Great Depression intensified in 1930, financial institutions were hit hard along with trade; in 1930 alone 1345 US banks collapsed. During the 1930s the United States raised trade barriers, refused to act as an international lender of last resort, and refused calls to cancel war debts, all of which further aggravated economic hardship for other countries.

The Bretton Woods Era: 1945–1971: The Bretton Woods system of monetary management established the rules for commercial and financial relations among the world's major industrial states in the mid 20th century. The Bretton Woods system was the first example of a fully negotiated monetary order intended to govern monetary relations among independent nation-states.



Preparing to rebuild the international economic system as World War II was still raging, 730 delegates from all 44 Allied nations gathered at the Mount Washington Hotel in Bretton Woods, New Hampshire, United States, for the United Nations Monetary and Financial Conference. The delegates deliberated upon and signed the Bretton Woods Agreements during the first three weeks of July 1944.

Setting up a system of rules, institutions, and procedures to regulate the international monetary system, the planners at Bretton Woods established the International

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Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD), which today is part of the World Bank Group. These organizations became operational in 1945 after a sufficient number of countries had ratified the agreement.

There was a growing need to develop a system of international payments that would allow trade to be conducted without fear of sudden currency depreciation or wild fluctuations in exchange rates. The Bretton Woods System fulfilled this need of international trade.

The chief features of the Bretton Woods system were an obligation for each country to adopt a monetary policy that maintained the exchange rate by tying its currency to the U.S. dollar and the ability of the IMF to bridge temporary imbalances of payments.

Bretton Wood System: Free trade relied on the free convertibility of currencies. The economists of that time concluded that major monetary fluctuations could stall the free flow of trade.

The new economic system required an accepted vehicle for investment, trade, and payments. Unlike national economies, however, the international economy lacks a central government that can issue currency and manage its use. In the past this problem had been solved through the gold standard, but the architects of Bretton Woods did not consider this option feasible for the postwar political economy. Instead, they set up a system of fixed exchange rates managed by a series of newly created international institutions(like IMF) using the U.S. dollar (which was a gold standard currency for central banks) as a reserve currency.

The system required other countries would peg their currencies to the U.S. dollar, and—once convertibility was restored—would buy and sell U.S. dollars to keep market exchange rates within plus or minus 1% of parity. Thus, the U.S. dollar took over the role that gold had played under the gold standard in the international financial system.

To bolster faith in the dollar, the U.S. agreed separately to link the dollar to gold at the rate of $35 per ounce of gold. At this rate, foreign governments and central banks were able to exchange dollars for gold. Bretton Woods established a system of payments based on the dollar, in which all currencies were defined in relation to the dollar, itself convertible into gold, and above all, "as good as gold". The U.S. currency was now effectively the world currency, the standard to which every other currency was pegged. As the world's key currency, most international transactions were denominated in US dollars.

This system lasted till 1971: On August 15, 1971, the United States unilaterally terminated convertibility of the dollar to gold. As a result, "The Bretton Woods system officially ended and the dollar became fully 'fiat currency,' backed by nothing but the promise of the federal government." This action, referred to as the Nixon shock, created the situation in which the United States dollar became a reserve currency used by many states. At the same time, many fixed currencies (such as GBP, for example), also became free floating.

The Post Bretton Woods System: 1971 – Present: Towards the end of the Bretton Woods era, the central role of the dollar became a problem as international demand eventually forced the US to run a persistent trade deficit, which undermined confidence in the dollar. This, together with the emergence of a parallel market for gold where the price soared above the official US mandated price, led to speculators running down the US gold reserves. Even when convertibility was restricted to nations only, some, notably France, continued building up hoards of gold at the expense of the US. Eventually these pressures caused President Nixon to end all convertibility into gold on 15 August 1971. This event marked the effective end of the Bretton Woods systems; attempts were made to find other mechanisms to preserve the fixed exchange

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rates over the next few years, but they were not successful, resulting in a system of floating exchange rates.

An alternative name for the post Bretton Woods system is the **Washington Consensus**. While the name was coined in 1989, the associated economic system came into effect years earlier.

Floating Exchange Rate: A floating exchange rate or fluctuating exchange rate is a type of exchange rate regime wherein a currency's value is allowed to fluctuate according to the foreign exchange market. A currency that uses a floating exchange rate is known as a floating currency.

In the modern world, the majority of the world's currencies are floating. Central banks often participate in the markets to attempt to influence exchange rates. Such currencies include the most widely traded currencies. The Canadian dollar most closely resembles the ideal floating currency as the Canadian central bank has not interfered with its price since it officially stopped doing so in 1998. The US dollar runs a close second with very little changes in its foreign reserves; by contrast, Japan and the UK intervene to a greater extent.

Fixed Exchange Rates: There are two ways the price of a currency can be determined against another Fixed Rate and Floating Rate. A fixed, or pegged, rate is a rate the government (central bank) sets and maintains as the official exchange rate. A set price will be determined against a major world currency (usually the U.S. dollar, but also other major currencies such as the euro, the yen or a basket of currencies). In order to maintain the local exchange rate, the central bank buys and sells its own currency on the foreign exchange market in return for the currency to which it is pegged.

If, for example, it is determined that the value of a single unit of local currency is equal to US$3, the central bank will have to ensure that it can supply the market with those dollars. In order to maintain the rate, the central bank must keep a high level of foreign reserves. This is a reserved amount of foreign currency held by the central bank that it can use to release (or absorb) extra funds into (or out of) the market. This ensures an appropriate money supply, appropriate fluctuations in the market (inflation/deflation) and ultimately, the exchange rate. The central bank can also adjust the official exchange rate when necessary.

Floating Exchange Rates: Unlike the fixed rate, a floating exchange rate is determined by the private market through supply and demand. A floating rate is often termed "self-correcting," as any differences in supply and demand will automatically be corrected in the market. Look at this simplified model: if demand for a currency is low, its value will decrease, thus making imported goods more expensive and stimulating demand for local goods and services. This in turn will generate more jobs, causing an auto-correction in the market. A floating exchange rate is constantly changing.

In reality, no currency is wholly fixed or floating. In a fixed regime, market pressures can also influence changes in the exchange rate. Sometimes, when a local currency reflects its true value against its pegged currency, a "black market" (which is more reflective of actual supply and demand) may develop. A central bank will often then be forced to revalue or devalue the official rate so that the rate is in line with the unofficial one, thereby halting the activity of the black market.

In a floating regime, the central bank may also intervene when it is necessary to ensure stability and to avoid inflation. However, it is less often that the central bank of a floating regime will interfere.

A free floating exchange rate increases foreign exchange volatility. There are economists who think that this could cause serious problems, especially in emerging economies. These economies have a financial sector with one or more of following conditions:

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- High liability dollarization
- Financial fragility
- Strong balance sheet effects

When liabilities are denominated in foreign currencies while assets are in the local currency, unexpected depreciations of the exchange rate deteriorate bank and corporate balance sheets and threaten the stability of the domestic financial system.

For this reason emerging countries appear to face greater fear of floating, as they have much smaller variations of the nominal exchange rate, yet face bigger shocks and interest rate and reserve movements. This is the consequence of frequent free floating countries' reaction to exchange rate movements with monetary policy and/or intervention in the foreign exchange market.

Date	System	Reserve assets	Leaders
1803–1873	Bimetallism	Gold, silver	France, UK
1873–1914	Gold standard	Gold, pound	UK
1914–1924	Anchored dollar standard	Gold, dollar	US, UK, France
1924–1933	Gold standard	Gold, dollar, pound	US, UK, France
1933–1971	Anchored dollar standard	Gold, dollar	US, G-10
1971–1973	Dollar standard	Dollar	US
1973–1985	Flexible exchange rates	Dollar, mark, pound	US, Germany, Japan
1985–1999	Managed exchange rates	Dollar, mark, yen	US, G7, IMF
1999-	Dollar, euro	Dollar, euro, yen	US, Eurozone, IMF

GLOBALIZATION

Globalization (or Globalization) refers to the increasingly global relationships of culture, people, and economic activity. It is generally used to refer to economic globalization: the global distribution of the production of goods and services, through reduction of barriers to international trade such as tariffs, export fees, and import quotas. Globalization contributes to economic growth in developed and developing countries through increased specialization and the principle of comparative advantage. The term can also refer to the transnational circulation of ideas, languages, and popular culture.

Financial Globalization is understood as the integration of a country’s local financial system with international financial markets and institutions. This integration typically requires that governments liberalize the domestic financial sector and the capital account. Integration takes place when liberalized economies experience an increase in cross-country capital movement, including an active participation of local borrowers and lenders in international markets and a widespread use of international financial intermediaries. Although developed countries are the most active participants in the financial globalization process, developing countries (primarily middle-income countries) have also started to participate.

Financial Globalization and Financial Integration is, in principle different concepts. Financial globalization is an aggregate concept that refers to rising global linkages through cross-border financial flows. Financial integration refers to an individual country’s linkages to international capital markets. Clearly, these concepts are closely related. For instance, increasing financial globalization is perforce associated with rising financial integration.

Today, despite the perception of increasing financial globalization, the international financial system is far from being perfectly integrated. There is evidence of persistent capital market segmentation, home country bias, and correlation between domestic savings and investment. The recent deregulation of financial systems, the technological

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advances in financial services, and the increased diversity in the channels of financial globalization make a return to the past more costly and therefore more difficult. Financial globalization is unlikely to be reversed, particularly for partially integrated economies, although the possibility of that happening still exists.

The potential benefits of financial globalization will likely lead to a more financially interconnected world and a deeper degree of financial integration of developing countries with international financial markets. The main benefit of financial globalization for developing countries is the development of their financial system, what involves more complete, deeper, more stable, and better-regulated financial markets.

Types of Global Financial Integration:

When assessing the benefits and risks of Financial Integration, it is useful to identify four types of financial integration:

1. Integration of the public sector by way of sovereign borrowing, which can take two forms: the issuance of foreign-currency debt, whether under foreign or domestic law, and the issuance of local-currency debt which foreigners can purchase on the issuer's home market.
2. Integration of the corporate sector by way of foreign direct investment, as well as cross-border borrowing and equity issues in other countries' markets.
3. The further integration of the corporate sector that occurs when institutional and individual investors buy and sell the stocks and bonds of other countries' firms in those countries' asset markets.
4. The integration of the banking sector by way of the worldwide interbank market in which they can borrow or lend temporarily— the option exercised with dire consequences by some of the East Asian countries' banks a few years ago.

Risk and Opportunities of Financial Globalization: Critics of globalization allege that globalization's benefits have been overstated and its costs underestimated. Critics argue that it has decreased inter-cultural contact while increasing the possibility of international and intra-national conflict.

Against the background of the many complex controversies about globalization, the challenges facing individuals and institutions that participate in the international financial system are daunting.

This is for three reasons: First, with respect to our domestic economies, the level of understanding about the role of finance is very limited. It is not easy to establish conclusively the positive linkages between the activities of Wall Street (Stock Markets) and the activities of Main Street (Economy). For example, it is hard to explain the connection between deposits in banks or purchases of equities and the Economist's concept of investment, in the sense of savings and investment as they are recorded in the national income accounts.

Second, and still in the context of our domestic economies, even for those with some definite feel for the role of finance in a market economy, the general feeling among those who borrow money or take on debt is that those who lend or manage money are exploitative by nature. The local banker receives a certain degree of respect in his community, but one is hard pressed to find expressions of fondness or warmth for large financial institutions.

Third and finally, turning to the international financial arena, two ingredients strongly influence historic trends in international finance: integration and technical change. These basic forces have shaped the evolution of international finance for centuries. Global integration of money and capital markets is the essence of international finance; through such channels purchasing power over real resources today is transferred from areas of the world where expected rates of return are lower to areas of the world where expected rates of return are higher. This process, in turn, is facilitated in important

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respects by technical changes that have helped to speed not only the flow of funds but also the flow of information about investment opportunities.

Significant portion of the debate about globalization and its effects on the real economy revolves around what portion of the process that supporters of globalization call "creative destruction" is attributable to trends in global integration, on the one hand, and what portion is attributable to trends in technical change, on the other hand. If one can establish that a significant share of the process of disruptive change in our economies is due to technical change, not global integration, the debate about globalization, clearly becomes one about whether one favors economic growth and progress or not, which is a somewhat easier debate for the pro-globalizers in which to prevail. Of course, it is a challenge to try to disentangle the influence of those two trends in assessing the performance of the real economy, for example, with respect to job losses, but many observers are convinced that they are separable, at least at the conceptual level. Thus, the defenders of globalization in the area of trade make the point that the economic effects of technical change should not be attributed primarily to the influence of globalization. When it comes to international finance, such an attempt to separate global integration from technical change is not convincing, even as a debating point.

International finance is particularly vulnerable to those who oppose increased globalization because the role of finance in our economies is poorly understood, financiers don't win popularity contests, and it is essentially impossible to separate the process of technical change from the process of global integration when it comes to international finance.

THE RISKS OF FINANCIAL GLOBALIZATION

There are four major risks associated with Global Financial Integration: First, when a country liberalizes its financial system it becomes subject to market discipline exercised by both foreign and domestic investors. When an economy is closed, only domestic investors monitor the economy and react to unsound fundamentals. In open economies, the joint force of domestic and foreign investors might generate a crisis when fundamentals deteriorate. This might prompt countries to try to achieve sound fundamentals, though this might take a long time. Furthermore, investors might overreact, being over-optimistic in good times and over-pessimistic in bad ones, not necessarily disciplining countries. Therefore, small changes in fundamentals, or even news, can trigger sharp changes in investors' appetite for risk.

Second, globalization can also lead to crises if there are imperfections in international financial markets. The imperfections in financial markets can generate bubbles, herding behavior, speculative attacks, and crashes among other things.

Imperfections in international capital markets can lead to crises even in countries with sound fundamentals. For example, if investors believe that the exchange rate is unsustainable they might speculate against the currency, what can lead to a self-fulfilling balance of payments crisis regardless of market fundamentals. For example, moral hazard can lead to over borrowing syndromes when economies are liberalized and there are implicit government guarantees, increasing the likelihood of crises.

Third, globalization can lead to crises due to the importance of external factors, even in countries with sound fundamentals and even in the absence of imperfections in international capital markets. If a country becomes dependent on foreign capital, sudden shifts in foreign capital flows can create financing difficulties and economic downturns. These shifts do not necessarily depend on country fundamentals. External factors are important determinants of capital flows to developing countries. For Example World Interest Rates were a significant determinant of capital inflows into Asia and Latin America during the 1990s. Economic cyclical movements in developed countries, a global drive towards diversification of investments in major financial centers, and regional effects tend to be other important global factors.

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Fourth, financial globalization can also lead to financial crises through contagion, namely by shocks that are transmitted across countries. Three broad channels of contagion have been identified in the literature: real links, financial links, and herding behavior or "unexplained high correlations."

Real links have been usually associated with trade links. When two countries trade among themselves or if they compete in the same external markets, a devaluation of the exchange rate in one country deteriorates the other country's competitive advantage. As a consequence, both countries will likely end up devaluing their currencies to re-balance their external sectors.

Financial links exist when two economies are connected through the international financial system. One example of financial links is when leveraged institutions face margin calls. When the value of their collateral falls, due to a negative shock in one country, leveraged companies need to increase their reserves. Therefore, they sell part of their valuable holdings on the countries that are still unaffected by the initial shock. This mechanism propagates the shock to other economies.

Finally, financial markets might transmit shocks across countries due to **herding behavior** or panics. At the root of this herding behavior is asymmetric information. Information is costly so investors remain uniformed.

Therefore, investors try to infer future price changes based on how other markets are reacting. In this context, a change in Thailand's asset prices might be useful information about future changes in Indonesia or Brazil's asset prices. Additionally, in the context of asymmetric information, what the other market participants are doing might convey information that each uniformed investor does not have. This type of reaction leads to herding behavior, panics, and "irrational exuberance."

What risks, if any, may the Central Banks and Global Economy confront due to financial globalization?

The risks of a major accident, another Long-Term Capital Management (LTCM), are more likely to be home-grown, not imported from international markets. There is, however, one risk that could perhaps be imported. The European Central Bank (ECB) may have great difficulty dealing with a major banking crisis in the euro zone. This is not for the reason sometimes cited—that the ECB is not well-capitalized and there is no single government to guarantee its solvency. The monetary operations of the euro-system are conducted by the national central banks, not the ECB itself, and each of them has a government to guarantee its solvency. The weakness of the ECB resides in the fact that it has no direct access to the information it may need to detect an incipient crisis. It is wholly dependent on the national central banks and on those other agencies in the euro zone that are directly responsible for bank supervision. There an increasingly strong case for the centralization of bank supervision in the euro zone, whether by vesting it in the ECB or in some other EU body.

Several emerging-market countries are in far better shape today than they were a decade ago. Some have adopted more flexible exchange rates, including some East Asian countries, and many have accumulated far larger reserves than they held a decade ago, thanks to the very high prices of their principal exports, resulting in part from China's voracious demand for a wide range of primary products.

Some have also reduced their governments' foreign-currency debts, and their banks are far less heavily reliant on short-term foreign currency borrowing to fund domestic lending.

Nevertheless, financial integration has produced a new form of vulnerability. Foreign purchases of equities and domestic-currency debt have grown rapidly in the last few years, and foreign portfolio investments exceed direct investments in some emerging market countries, including Brazil, India, Indonesia, Israel, Korea, the Philippines,

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Turkey, and Uruguay. Any loss of confidence by holders of those claims, whether due to economic or political developments within the country or a worsening of global economic conditions, could lead to sales of those claims.

The effects of an exodus of foreign investors would, of course, be different from those of a sovereign debt crisis. They would be mitigated, moreover, by a fall in the domestic-currency prices of the country's stocks and bonds, as well as a depreciation of the country's currency if its exchange rate was sufficiently flexible. But the need to contain the depreciation could greatly reduce the country's reserves and amplify the exodus of foreign investors. The form of the next emerging-market crisis might thus differ from those of the recent past, but it would be utterly unrealistic to argue, as some do, that we are unlikely to see more crises in the future.

We come finally to the risk that resides in the way that the United States has exploited financial globalization to finance its current account deficit and, indirectly, its budget deficit. It is doubtful that the main foreign holders of dollars will start to sell them merely because they believe that the dollar will fall someday soon. The Chinese, for example, have said more than once that they will not reduce their dollar holdings, although they may diversify at the margin, swapping newly acquired dollars for euros, yen, and other International Currencies (including, incidentally, other Asian currencies). But it remains to be seen how they can achieve an orderly depreciation of the dollar of the size required without triggering massive dollar sales by foreign holders, including those of the OPEC countries and other official entities. Once it begins, a depreciation of that large size is apt to become a disorderly flight. The actual depreciation may indeed be larger than the one required to reduce sufficiently US current account deficit, and it is likely to take place over a time span far shorter than the one required for the weaker dollar to afford a significant stimulus to the U.S. economy—the switching of expenditure to domestic goods. In fact, its effects on U.S. interest rates could have a depressing effect on the U.S. economy larger than the stimulus afforded by the expenditure-switching effect of the depreciation.

The unwinding of global imbalances requires action by others, not just the United States

Conclusion: The global financial system is a source of strength but likewise a source of risk, and thus it calls for close cooperation among the world's major countries.

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