Globalization and its Effects on Financial Markets

Lecturer Sorin Claudiu RADU, PhD
„Dimitrie Cantemir” Christian University

Abstract
This paper addresses aspects of globalization, a process which has become a symbol of the present days and an important factor of change for international financial markets. The paper highlights the main economic benefits and risks of financial globalization, its impact on financial markets and the premises for the extent of the economic crisis.

Key words: globalization, financial markets, regulation, free markets, crisis.

1. Economic benefits and risks of the financial crisis

The term “globalization” was used for the first time in the Merriam Webster Dictionary in 1961, but it became common in the 80s, when it referred to the technological progress which facilitated international transactions.

Financial globalization is the result of innovation and technologic progress with a series of advantages, such as: extent of the outlet for the products and services offered by companies, positive effects from the selective use of the earth resources, good and cheap mass products by focusing on international companies and, at the same time, it can also lead to negative effects especially for poor countries which are not prepared for this phenomena.

There is growing inequality in most countries and globalization is one of the factors that contributed to this world pattern. The promise of globalization is that “everyone will gain something from it”, but in reality: some are very well while others are suffering.

This aspect of the phenomena is highlighted by Joseph E. Stiglitz in his work “Globalization. Hopes and Disillusions” where he said that: „I witnessed directly the devastating effect of globalization on the developing countries end especially on their poor population”. In many cases, the poor countries’ opening towards globalization was imposed by rich countries, not for the advantage of the former. In the beginning, this was done under the threat of weapons and raw force. Now, this process continues but has changed its methods. „Today, the emerging markets are not forced to collaborate under the force of arms, but due to economic power and threat of sanctions and redraw of help necessary during recession periods”.

Within globalization, most countries have come to privatize companies and financial institutions totally or partially owned by the state. These countries have deregulated finances and industry, liberalized international trade and direct foreign

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investments and cut income taxes and social income. But, as markets are not perfect, even the prophet of the free market, Milton Friedman admits that these markets sometimes fail, and these measures did not always have the desired results. Thus, mass privatization of state-owned companies has led to their lesser contribution to the national income and to lesser investment in many, but not all, countries. Growth of free trade and foreign investment have contributed to lower salaries and deregulation allowed trading companies to gain higher profits which were due especially to the power of exploitation of monopoly powers and freedom in the field of ecology and also due to redundancy.

As The Economist says, the present era of globalization is characterized by cut of telecommunication costs, but it is obvious the fact that globalization itself has opened new ways to world monopoly⁵. The present system, the globalization creation, is characterized by the “presence of terrible poverty”, „the need for foreign assistance and debt effacement” for the poor countries, the need to support fair trade, to overcome “the limits of liberalization”, the importance to protect the environment protection and change of “inefficient global governing system” (Stiglitz, 2006).

A part of the contemporary famous economists believe that most international institutions, most of them created after the Conference of Bretton Woods in 1944, whose aim is to support globalization, are also responsible for the huge discrepancies which, due to their functioning, create advantages for the countries that laid its bases. These institutions are the “World Bank, International Monetary Fund, International Regulations Bank, World Trade Organization, the group of the Developed Counties, United Nations Organization, and World Health Organization”⁶. IMF itself admits that globalization did not lead to growth and efficiency and did not support financial stability as it had predicted and hoped. I consider that for globalization to be efficient for all countries, it is necessary to reform these institutions so that they become democratic and equitable.

2. Impact of globalization on financial markets

The financial market is considered as the most dynamic market and starter for globalization when it succeeded to become globally liberal. It aimed to obtain profit without taking into account the aspects related to it. For this reason, for many economists, it is guilty for having imposed certain economic regulations that were too strict and which advantaged only those who had imposed them on the market. At the same time, it is criticized for not having tried to create a strategy according to which the countries willing to undergo globalization could fulfill international requirements and standards.

During the last decades, financial innovation increased financial mediation but led to lower transparency of the financial markets which is beyond undesirable. Financial innovation has the ability to grow the efficiency of certain transactions using financial instruments but the opaque markets grow incertitude and produce instability highlighting the systemic risks. Innovation was directed to by-pass regulations, accounting norms and fiscal norms.

The deriving financial instruments are amongst the innovations that pride the capital markets the most. The name gives a lot of details: their value derive from an asset. A bet on the possibility that next month the price of a share exceeds ten dollars is an

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⁵ Adam Smith has noticed the dangers and the modern laws against trusts were ment to keep a competitive market environment and predict anticompetition abusive actions.

extension. A bet on the possibility that the market value of a share will exceed ten dollars next month is an extension based on another extension. Thus, we could invent a multitude of such products. Extensions are a two-edged sword. On the one hand, they can be used in order to manage risks.

In an era of deregulations, the financial markets had created such complex products, that even if we had known their details, nobody could fully understand their effects regarding risks. The resulting financial products were so complex that analysts needed highly specialized computerized patterns in order to evaluate them. For this reason, Warren Buffet, American financial expert who was realistic about investments along the time, called these financial instruments „financial mass destruction weapons”, before the 2008 recession proved their toxicity.

In general, these new instruments could improve risk management – even cut the costs of transaction. In practice, they allowed people make risky investment bets on higher sums of money and with less own capital. The new financial instruments (swaps on credit risks) created to manage risks, but in reality equally designed to bitter regulators, were so complex that they increased risks.

Financial markets willingly created complex products in order to reduce transparency without breaking obvious rules.

The present financial crisis is based on the increased use of derived financial instruments which are not transparent or effective use on financial markets. For this reason, the financial markets have become more and more opaque and the identity of those who took risks and their correct evaluation wish.

As derivates can be a useful risk management tool, they must not be forbidden but regulated so that they can be used accordingly. There must be total transparency, efficient concurrence and a sufficient “extent” to be sure that the parts can fulfill their obligations taken by investment bet and the most important of all, it should not be allowed for the extensions to endanger the financial system. In order to reach these objectives, a few things must be done: swaps on credit risks and other deriving instruments must be limited to the organized stock exchange and institutions where risk is covered.

Rigorous and efficient regulation of the financial markets has the role to avoid important, direct or collateral loss.

The capital market, considered the star of the financial market, needs regulations regarding financial instruments so that transparency of the markets is redone and investors are adequately informed on the risks they take”.

Certain malfunctions of the financial markets are based on market liberalization at any costs and which could be avoided by a strict control of this market and the desire to avoid any excess.

3. Markets do not self regulate

Amazingly, in 1980s, in a climate of globalization, the belief that the market is efficient and self-regulatory was predominant not only for the conservators but also for the American academic economists.

The economists form the Keynesian school such as Nouriel Roubini, George Soros, Stephen Roach and Robert Wescott, warned about the non-regulatory nature of

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markets.

At the beginning of the 80s, Great Britain, the USA, and many other countries considered that, in a different system, it is easier to make profit from financial operations than from economic activity. Based on this reasoning, the financial sector in the USA determined several goods producers turn into financial companies. Companies such as GE, GM and Ford became “financers” and at the beginning of the XXIst century, they are making a great part of financial profits but not due to their production.

The decisions aimed at deregulation “were the consequences of political and economic forces – interests, ideas, ideologies that transcended the level of individualities, whatever they may are”. In antithesis with the expectations of deregulation, the policies of the free market finally led to a slower economic growth and worsening of inequalities between the states and sometimes the areas of the same country, at political, economic and sometimes social levels.

Worldwide, too much innovation aimed at cutting the extent of work force and too little innovation was oriented towards saving natural resources and environment preservation – which is not at all surprising, having in view the fact that prices do not reflect the disparity of these natural resources. In many places of the world, handcraft spare was so successful that there is a major problem in unemployment rate. But success regarding spare of natural resources was so little, that we risk a collapse of the environment.

The world economic expansion during the period of deregulations did not prove that the open markets work, as growth was based on a huge pile of debt, but the fact that the growth was fragile. Today, after 2008, the year of the great recession breakout, almost everyone believes that regulation is needed – or at least more regulations than before the economic crisis. The lack of the necessary regulations had a huge cost on the global economy: economic crises would have been less frequent and the expenses for regulation agencies and the regulations themselves would be a small amount by report to these costs. The crisis made it clear that self regulation does not work.

4. Globalization of financial markets – premises for the present crisis

When experts try to identify the reasons that laid the bases for the present crisis, they need to attentively notice he role played by globalization which was a strong force for the change of financial markets.

Globalization of financial markets and financial innovation, on the background of precarious or inexistent regulations, and the conflicts made possible the present crisis.

“The seeds of destruction” were placed, says Stiglitz, in the ’90s. Economic globalization is before political globalization and at the end of the Cold War; there were no possibilities to set the grounds of a new world economic order, “a more correct order, based on social justice premises, which could offer countries a more equitable game (Stiglitz, 2008). After 2001, the philosophy of regulation, which was promoted and put in practice by Margaret Thatcher and transformed the idea of private initiative freedom into its caricature, that is excessive freedom to fall and mistake, says Stiglitz, and the freedom of the financial markets, not followed by adequate regulations, leads to economic instability”. This turned

8 Great Britain accelerated its deregulation programme with the so-called “Big Bang” of deregulations and the USA reacted with the abolishment, in 1999, of the law Glass-Steagall of 1933, cancelling the boundaries that separated the banking border from commercial and banking operations proper to American finances ever since 1929-1933.

9 Joseph E. Stiglitz - In free fall, Public Printing House, Bucharest, 2010, p. 23
true in 2008 when world economy was deeply affected by the great recession. A few factors led to the present crisis. One of them is the economy’s inert cyclic movement. The dramatic drop of interest in the USA after the stock exchange collapse at the end of the last decade was an intercession in order to avoid panic of the financial markets after September 11, 2001. This propelled credits. And took place on the grounds of the financial markets globalization and a more intense use of financial/extras innovations. In other words, in the short run, the financial sector helped the extended and diversified companies but this was done due to the fact that liquid financial goods have a dangerous potential for the rest of the economy and the short term effect is the apparition of economic instability as the liquid capital circulates irrationally. In the long run, the growth of production is diminished because long term investments are cut. The result is that, in spite of the progress in financial theory, there has been recorded a total slow of the financial field. In order to avoid future financial crises, action freedom on the financial market must be restricted. Transactions that are supported by highly risky financial instruments must be forbidden for the investors who cannot fully understand their functioning as well as their effects on the financial sector and on economy in general. The complex financial instruments, must be forbidden as their functioning and impact were overcome by the understanding of the so-called experts. If we want to prevent another crisis as the 2008 crisis, I believe that we must forbid all complex financial instruments if they are not proved to be useful to long-run economic growth. For this, we must introduce a process of analysis and evaluation of each new financial instrument according to its long run and not only short run risks and benefits for the entire system.

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10 Ha-Joon Chang – 23 things you are not told about capitalism, Polirom Printing House, Iași, 2011, p. 183