

# Global Financial Markets at the Turn of the Century

Edited by

Ilhan Meric

*Rider University and*

Gulser Meric

*Rowan University*



3001

1'ERGAJVION

An imprint of Elsevier Science

Amsterdam - London - New York - Oxford - Paris - Shannon - Tokyo

ELSEVIER SCIENCE Ltd The Boulevard, Langford Lane Kidlington, Oxford OX5 1GB, UK,

SJ 2001 Elsevier Science Ltd. All rights reserved

This work is protected under copyright by Elsevier Science, and the terms and conditions apply to its use:

terms and conditions

#### Photocopying

Single photocopies of single chapters may be made for personal use as allowed by national copyright laws. Permission of the Publisher for payment of a fee is required for all other photocopying, including multiple or systematic copying, copying for advertising or promotional purposes, resale, and all forms of document delivery. Special rates are available for educational institutions that wish to make photocopies for non-profit educational classroom use.

Permissions may be sought, directly from Elsevier Science Rights & Permissions Department, PO Box 800, Oxford OX1 1IX, UK; phone: (+44) 1865

fits: (+44) 1865 843930; fax: (+44) 1865 853333; e-mail: [permissions@elsevier.com](mailto:permissions@elsevier.com)

or you may also contact Rights & Permissions directly through Elsevier's home page (<http://www.elsevier.com/locate/permissions>), by selecting 'Obtaining Permissions'.

In the USA, users may clear permissions and make payments through the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, USA; phone: (978) 7508400, fax: (978) 7504744, and in the UK through the Copyright Licensing Agency Rapid Clearance Service (CLARCS), 90 Tottenham Court Road, London W1P 0LP, UK; phone: (+44) 207 631 5555; fax: (+44) 207 631 5500. Other countries may have a local reprographic rights agency for payments. Derivative Works

Tables of contents may be reproduced for internal circulation, but permission of Elsevier Science is required for external resale or distribution of such material.

Permission of the Publisher is required for all other derivative works, including compilations and translations.

#### Electronic Storage or Usage

Permission of the Publisher is required to store or use electronically any material contained in this work, including any chapter or part of a chapter.

Except as outlined above, no part of this work may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without prior written permission of the Publisher.

Address permissions requests to: Elsevier Science Rights & Permissions Department, at the mail, fax and e-mail addresses noted above.

#### Notice

No responsibility is assumed by the Publisher for any injury and/or damage to persons or property as a matter of products liability, negligence or otherwise, or from any use or operation of any methods, products, instructions or ideas contained in the material herein. Because of rapid advances in the medical sciences, in particular, independent verification of diagnoses and drug dosages should be made. First edition 2001

#### Library of Congress Cataloging in Publication Data

Global financial markets at the turn of the century/edited by Ilhan Meric and Guiseppe Meric, p. cm. - (Series in international business and economics) Includes bibliographical references and index. ISBN 0-08-043798-2 (alk. paper) I. Financial institutions. 5. Finance. I. Meric, Ilhan. II. Meric, Guiseppe. III. Series. IE(J17?..GSB5 2001

S32^dc21

00-055448

British Library Cataloguing in Publication Data Global financial markets at the turn of the century I. Financial institutions 2- Finance I.-Meric, Ilhan II, Meric, Guiseppe

332

ISBN 0-08-043798-2

Typeset by The Midlands Book Typesetting Company, United Kingdom.

(The paper used in this publication meets the requirements of ANSI/NISO Z39.48-1992 (Permanence of Paper). Printed in The Netherlands,

# Banking, Economic Development and integration

**EDGAR ORTIZ and JEAN-PIERRE GUEYIE**

## Introduction

The importance of financial markets and financial institutions in economic development has been clearly established by numerous authors. A common denominator of these studies has been to recommend financial liberalization to enhance the role of financial markets and institutions, which are frequently 'repressed' in the developing economies by excessive regulation and high direct intervention of the state in the financial sector, by developing banking and direct controls on interest and credit allocations.

This policy has been followed by developing nations during the last two decades, in the aftermath of the debt crisis and induced by- economic and financial globalization. Among other 'modernization' changes, these countries have implemented profound reforms in their financial sector to be able to open up their economies advantageously to the world markets and achieve high and sustained rates of economic development. An alternative strategy, for responding to the challenges of global competitive markets and enhancing development, has been to promote economic integration which, on a worldwide basis, has led to the formation of strong economic blocs. Both economic development and economic integration depend significantly on the soundness of local financial markets and institutions and their capacity to respond to those two challenges. At the end of the of the twentieth century, the world's global economic and political scenario changed substantially due to the fall of the Berlin Wall and the re-unification of Germany, the fall of State-led (totalitarian) socialism, and above all, the end of the 'cold war'. The world is therefore undergoing a true transition towards a new economic order led by free markets and their institutions.

Banking institutions are accordingly called to play an important role in the new developing processes of both emerging and transition economies<sup>1</sup>. Financial literature has studied banking institutions in these countries extensively during the last few years. However, those studies have been limited to examining the nature of banking crisis, neglecting to assess the role of the banking sector on economic development and economic integration.

This chapter aims to overcome such limitation by building up a conceptual framework to analyse the role of banking institutions in developing nations in the context of economic development tempered by economic liberalization and economic integration schemes. This is a necessary step in the path to strengthen, in the forthcoming decades of the new millennium, deregulation and liberalization policies that can prevent re-occurrences of twin currency and banking crisis in the developing and transition economies, and similarly prevent costly banking rescue programmes<sup>2</sup>.

## **Financial Intermediation and Economic Development**

### ***Financial Assets and Institutions and Growth***

Economic theory presents astonishingly different views concerning the importance of the financial system for economic development. In deep contrast to the dominant theories, which express either skepticism or lack of interest about the role of financial markets and institutions in development, the theories on financial development pioneered by Gurley and Shaw (1960), Goldsmith (1968, 1969), McKinnon (1973), Bennet (1965), Patrick (1966), Shaw (1973) and later further elaborated by Fry (1988, 1989), Galbis (1977), Gupta (1984), Ortiz (1993; 1995) and others<sup>3</sup> maintain that the financial sector is important in development. The rate of growth and the quality of economic development of an economy depends not only on real variables and their technological parameters, but also on financial variables and their functional relationships with real variables. Equilibrium conditions for an economy can, therefore, be defined in terms of financial variables and financial markets (Gurley and Shaw, 1960, p. 3).

Furthermore, financial development theories also define the role of financial institutions in development. Financial institutions can promote economic development by assuming, in the provision of their services and lending power, an innovative supply-leading role rather than a demand-following approach to development. Certain financial intermediation techniques can be developed to enhance the process of economic growth. To this category belong financial techniques such as efficient credit management, improved communications, lower transaction costs, innovations, and especially the development of various types of securities and their markets, and the development of financial intermediation institutions (Ibid, pp. 125-126).

Concretely, an economic system is an aggregate of spending units and financial intermediaries. Spending units engage primarily in the transaction of goods and services. Financial intermediaries specialize in financial transactions. Spending units include three sectors: (1) consumer households, which sell their labor services in exchange for wage income; (2) business firms, which own physical capital and combine it with labor services to produce national output; and (3) government spending units (independent of the government financial sector) (Ibid, pp. 13-14). Spending units are also divided into deficit spending units, and surplus spending units depending on whether their disposable income is less than or greater than their expenditure. Generally, households are surplus units and business firm are deficit units. This specialization by households in savings and by business enterprises in investment is the basis for debt, financial assets, and financial institutions, i.e., financial intermediation. The function of financial intermediaries is to promote the transfer of funds from savers to investors (Bennet, 1965, pp. 6-7).

The financial intermediation sector is composed of monetary intermediaries and non-monetary intermediaries, including government financial intermediaries. Monetary intermediaries, i.e. banking institutions, are those which have money as part of their liabilities. In the case of non-monetary financial intermediaries (mutual

savings banks, savings and loan associations, insurance companies, etc.), none of their liabilities are part of the medium of exchange (Ibid, pp. 6-7).

Financial intermediaries specialize in the transaction of financial assets. The term 'financial assets' refers to both primary and indirect securities. Primary securities are all the liabilities and outstanding equities of non-financial units; they are assumed to be issued only by the business sector. Indirect securities are the liabilities and equities of financial intermediaries, and can be further classified as money and non-monetary indirect securities. Money is a medium of exchange and it can be a liability of monetary intermediaries. Non-monetary indirect securities are all other liabilities of financial intermediaries, i.e., claims issued against themselves (Ibid, p.7)

Business firms finance their investment opportunities in three ways: (1) internal resources or self-financing through retained earnings; (2) direct financing by issuing direct securities which are purchased by households; and (3) indirect financing. Primary securities issued by business firms are purchased by financial intermediaries; the latter issue their own liabilities — indirect, securities — to surplus spending units (Goldsmith, 1968).

Indirect debt is the most advantageous to the economic growth of a nation. Self-financing would limit investment to the amounts of internal resources available. Similarly, direct financing can limit the size of investments made because the issues of business firms may not accommodate the portfolio needs and preferences of surplus spending units in terms of risk, liquidity, maturity; legal size, currency redeem ability, transaction costs, or any combination of these factors (Ibid, pp. 26-28).

To fully exploit the ability of a society to accumulate productive capital, it is therefore important to bridge the gap in needs and preferences between savers and investors. Financial intermediaries help to bridge this gap by issuing indirect debt in the form of financial assets tailored to the needs and preferences of households (Ibid, pp. 27-28). Thus, financial intermediaries develop when it is necessary or preferable to substitute indirect for direct external financing.

The existence of surplus and deficit units as well as financial assets to promote the transfer of funds is a necessary but insufficient condition for the development of financial intermediaries; funds could be transferred directly between surplus units and deficit units. However, no transfer of funds would take place if the financial instruments available could not meet the preferences of surplus units (Ibid, p. 25).

The existence of a channel of communication between savers and investors is, therefore, as important to economic expansion as savings themselves, for it permits access for needed funds (Gurley and Shaw, pp. 196-197). The capacity of growth in an economy could be limited by its financial system and its structure. With no financial assets other than money and direct debt, there are impediments to savings and capital formation. The inefficient allocation of savings to investment results in decreases in output and income. In contrast to an economy where there are developed markets and institutions for financial claims, a rudimentary economy would tend to attain lower levels of savings and investment at each level of income, and hence lower rates of economic growth (Ibid, p. 13).

### ***Financial intermediation and Efficiency in Savings and Investment***

Savings has been identified as the main factor determining investments and economic growth. Financial intermediation enhances them by specializing in the transaction of financial assets. Indeed, the *raison d'être* of economic specialization is efficiency. Financial intermediaries promote efficiency in the savings—investment process by (1) creating various and attractive financial assets and using efficient financial intermediation techniques; (2) exploiting economies of scale in lending and borrowing so that the marginal value of investments increases; and (3) regulating capital flows to make feasible at certain locations interdependent or large-scale indivisible projects.

Furthermore, financial intermediaries contribute to enhance the savings and investment processes in various ways:

1. As pointed out earlier, financial intermediation allows the mobilization of funds from surplus units to deficit units. In the absence of indirect debt, investment would be limited to the internal resources of an organization and, at most, by direct financing.
2. Intermediation techniques turn primary securities into indirect securities for the portfolio of ultimate lenders. By creating a wide variety of financial assets suited to the needs of ultimate lenders, financial intermediaries help ease the need of borrowers to issue securities which may not be appropriate for their type of business, for example, contractual insurance plans (Ibid, p.197). Specialization in financial intermediation allows investing units to concentrate on the efficient production of goods and services.
3. Intermediation techniques increase the level of savings. By creating assets suited to the needs of households, financial intermediaries help eliminate excess and/or surplus consumption. Consumers can purchase from financial intermediaries<sup>1</sup> financial assets to suit their needs and preferences, such as savings deposits, certificates of deposit, pension plans> insurance contracts, etc. In turn, financial intermediaries can purchase direct securities from business firms and finance their investments. As a general rule, the short-term securities issued by financial intermediaries are more liquid, more easily divisible, easier and less costly to transact, and less risky than direct securities. Long-term securities issued by financial intermediaries also share those characteristics, with the exception of transferability. In addition, long-term securities are tailored to fit households' needs, such as in the case of insurance and pension contracts (Ibid, p. 194).
4. Financial intermediaries bear risk and illiquidity. The reward for their operations comes from the difference between the rate of return between primary securities and indirect securities. Intermediaries can attain such economic gain by using economies of scale in borrowing and lending, and especially by efficient management of their portfolios.
5. Resource allocation becomes more efficient. Financial intermediaries and their techniques help to establish an efficient ordering of investments. By classifying investments more extensively by their own characteristics, financial intermediaries help to exclude the allocation of funds to inferior investments. Financial intermediaries are themselves selective in the process of fund allocation; in addition, direct financing also becomes more efficient

since the operations of financial intermediaries affect supply and demand for direct securities.

6. The creation of indirect securities to fund investments is not limited to cash balances of individual households. All financial intermediaries create financial assets. Monetary intermediaries create money when they purchase primary securities; non-monetary intermediaries create various forms of non-monetary indirect assets when they purchase money. The difference between monetary and non-monetary intermediaries is not that one creates and the other does not, but rather that each creates its own form of debt. Credit creation of this manner, with or without reserve requirements, is important to an economy. It allows it to increase its capacity to invest without simultaneous increases in goods and services, but rather in relation to the present value of existing investment opportunities.
7. Financial assets issued by financial intermediaries simplify and enhance portfolio selection from surplus units. In the first place, savers do not have to search through all types of securities to choose those which fit their needs. Second, indirect assets have, and introduce, a degree of differentiation themselves. Savers can choose not only between the assets offered by monetary and non-monetary financial intermediaries, but also some direct securities too. Thus, the portfolio of households can become more diversified.
8. Financial intermediaries also strengthen and enhance the efficiency and benefits of the savings—investment process by attaining economies of scale in lending and borrowing so that the utility of money increases. As Gutley and Shaw (1960) point out, on the lending side financial intermediaries can invest and manage investment on primary securities at unit costs well below the standards achieved by individual lenders. Also, large-size portfolios allow financial intermediaries to achieve a significant reduction in risk through financial asset diversification,
9. Finally, financial intermediaries can minimize liquidity crises by proper scheduling of the purchase of direct securities of different maturities, including long-term securities (Ibid). Similarly, on the borrowing side, financial intermediaries can attract a large number of depositors and rely fairly well on a schedule of claims for repayments; hence, they can operate with relatively illiquid portfolios (Ibid). In turn, financial intermediaries can distribute the advantages of their economies of scale in borrowing and lending to their debtors in the form of favorable terms of lending, to their creditors in the form of stable returns and other services, and to their stockholders in the form of adequate dividend payments, which may also help to attract additional capital funds (Ibid).

Thus, acting independently, individual investors cannot optimize their portfolio by diversification due to the limited amount of their savings as well as to the indivisibility of many direct financial assets; in addition, individual savers cannot usually support long-term investments due to their particular liquidity needs. The pooling of savings resources allows financial intermediaries to purchase different types of securities and minimize risk due to diversification. Hence, consistent with current portfolio theory, at certain levels of risk financial intermediaries can attain higher rates of return than would be feasible to individual savers; conversely, for a level of interest returns, financial intermediaries can attain lower levels of risk.

The pooling of funds and the channeling of investments through financial intermediaries are therefore advantageous to society. As pointed out earlier, the benefits of resource pooling are shared by financial intermediaries with savers and investors. In addition, the allocation of resources is more efficient through the selectivity of financial intermediaries; this means that, for equal levels of savings, a nation can achieve greater levels of output.

By controlling financial flows, financial intermediaries can improve the savings-investment process. First, financial intermediaries must choose direct securities to insure profitability. Thus the flow of funds from savers to investors is improved by an intermediate step to assess investment opportunities. Second, financial intermediaries can pool savings to support long-term, interdependent and indivisible projects, as previously observed in context with the use of economies of scale in borrowing and lending. Third, by establishing adequate channels of communication and transaction in various regions, financial intermediaries can help the free flow of financial assets in an economy. This is an important process in an economy, for it promotes factor price equalization. Finally, as corollary, financial intermediaries can increase the size of savings available at certain locations. Surpluses from certain regions can be pooled to support attractive high-return investments in other locations.

### ***Financial Liberalization and Development***

The ideas previously put forth assume liberated markets and fully fledged competition. This is consistent with economic integration which demands some degree of financial opening. However, following World War II, most developing economies enforced significant financial controls to promote economic development. In order to overcome low savings rates, traditional and lean investments carried out by an embryonic entrepreneurial sector, and to promote growth of some priority sectors, governments from developing countries placed ceilings on lending interest rates, marked savings rates, set credit allocations selectively, placing strict shares to each sector, favoring those considered important, and enforced controls on capital movements. Additionally, the state intervened directly in the economy by means of state-owned and -managed developing banks. These policies sent distorted signals to the market, promoted inefficiency among banks, and inhibited the growth of non-monetary intermediaries. Financial development theory always recommended financial liberalization and deregulation to enhance the role of financial markets and institutions that were frequently 'repressed' in the developing economics (Studart, 1998).

Nevertheless, developing countries resisted financial liberalization for many years. However several factors, among them the debt crisis of the 1980s, diminished returns derived from import substitution, and the accelerated growth and importance of economic and financial globalization induced those nations to adopt economic liberalism. Consequently, governments have enforced ambitious modernization programmes which mainly include opening up to foreign trade and investments, and financial liberalization and deregulation. The aim is increasing economic growth by taking full advantage of globalization. In addition, an alternative strategy for responding to the challenges of global competitive markets,



and enhancing development has been to promote economic integration, which, on a worldwide basis, has led to the formation of strong economic blocs.

Thus, although the functions of financial intermediaries remain the same, they must currently be carried out in a more complex environment than the one existing before the end of the cold war. It involves benefits and risks derived from economic and financial liberalization in a globalized economy, and the benefits and risks derived from regional economic integration. In this respect, both economic development and economic integration depend significantly on the soundness of local financial markets and institutions and their capacity to respond rapidly and efficiently to contemporary economic challenges.

### **Banks as Intermediaries and their Role in Development**

Banks are one of the most important financial intermediaries. In most developing countries they are the main component of the financial sector, since full-arms securities markets are still in the process of formation<sup>4</sup>. Essentially, their liabilities are primarily short- term deposits which compose part of a nation's money supply (they are monetary intermediaries), while their assets are short- and long- term loans to business firms, governments, and consumers.

In addition to all those financial intermediation practices previously identified, which promote economic development, for the specific case of banking institutions it should be first acknowledged that they constitute the payments system of a nation. In this respect, Tobin (1965) emphasized their role as instruments of monetary policy. They create money, and contribute to the country's money management. They mobilize savings through deposits, and make loans to agents in need of liquidity to realize their productive investments. They offer various financial products and services to their customers, and set up a wide system of payments.

Several authors point out that bank's loans are 'special' (Fama, 1984; James, 1987). They provide investors with valuable information about borrowers which is not available at financial markets. In this vein, Diamond (1984) presents banks as "delegated monitors". When the acquisition of information about a firm is costly, finance can be provided to firms in a more efficient manner if savers delegate the collection of information about firms to a financial intermediary, provided that the intermediary has appropriate incentives to act in the savers' interests. Even in the absence of such delegation, however, banks' actions, such as a new loan to a firm, can provide valuable information to the market, since they have access to a firm's privileged information.

Banks are also important participants in capital markets, and a useful complement to cover their insufficiencies. Because not all firms can meet the listing standards of securities markets, banking credit becomes the most, important source of funds for small and medium-sized firms. Similarly, because many financial assets offered in these markets are highly standardized, banks remain the only means of providing specific products to customers, in relation to their particular savings and investment needs.

Banks also support the development of capital markets. They often initiate many kinds of financial services which, once standardized, are provided to all agents in the financial markets. Recent developments, such as securitization of their assets, have reinforced their presence and role in capital markets. Banks' loans, instead of being held in their original form until maturity, are securitized and sold in financial markets.

Banks, therefore, participate in the national flow of funds process, either as main actors or as brokers. Their role in the economy is fundamental. A crisis in the banking sector can therefore affect the economy in general. According to Bernanke (1983), such a crisis yields a financial intermediation disruption, and affects the money and claims supply in the economy. He argues that the difficulties in the banking sector during the great depression of 1928 greatly affected the real sector.

In this respect, it is worth noting that an excessive predominance of the banking sector in an economy can be harmful to its development. Due to the lack of development of other forms of intermediation, savings and investment levels would remain restricted. Furthermore, this phenomenon might be accompanied by monopolistic practices which in turn would lead to high costs of capital in the economy, inhibiting even more the growth of the economy.

Similarly, the lack of arms-length financial markets leads to closed patterns of corporate governance and strong links between firms and banks. Corporations are owned and managed by family groups which show limited interest in expanding the operations of the firm in line with the innovative technological developments and competitiveness prevailing in international markets. Firms therefore remain small and non-competitive, inhibiting national growth- Strong ties between banks and corporations restrain growth of other forms of financial non-banking intermediation, which in turn leads to rigidity and inefficiencies in corporate decision-making.

## **Banking and Economic Integration**

### ***Benefits of Economic Integration***

Economic globalization has led to greater interdependence among nations. Moreover, countries throughout the world are not only closer to each other, but many have also committed themselves to enforce economic integration schemes with their main economic partners, which has led to the formation of large economic blocs such as the European Union, the North American Free Trade Agreement, and informally the Far Eastern economic bloc, headed by Germany and France, the United States, and Japan, respectively. Economic integration has been promoted because it offers important benefits which promote economic development. Among these benefits, the following must be mentioned:

1. Integration increases economic activity. First, it increases investment levels. Economic integration promotes the mobilization of international savings, which in turn overcomes limited local levels of savings, increasing investments and national output to higher levels. In short, corporations have greater access to international financing, and to international credits which support export activity. Empirical evidence shows that capital inflows amounting to 3-4 per cent in relation to GNP would increase it by 0,5 per cent (Reisen, 1996).

Development is also enhanced because economic integration increases returns on investments and savings. This is because there is a change towards more profitable economic activity at the international level. Similarly, foreign

direct investments also increase, which in turn boosts employment, output, exports and economic activity in general.

Finally, economic integration favours the adoption of new technologies. This increases productivity and makes firms from the participating members more competitive at the international level.

2. Economic integration strengthens entrepreneurship and advances new (open) patterns of corporate ownership and control, and improved corporate management. In order to become competitive at the international level, large family firms from developing countries seek external financing which widens ownership and enrol professional managers to the firm.
3. Concerning the financial sector, economic integration entails financial opening, which promotes competitiveness and efficiency of local financial markets and institutions. Integration leads to significant transfers of know-how and financial intermediation technologies; application of better forms of regulation; growth and efficiency of the securities markets. Economic integration brings about important financial innovations which lower the cost of capital and increase the level of investments. Finally, financial integration leads to better banking administration through the adoption of international norms and practices (World Bank, 1997).

In short, economic integration can be seen as an important engine for achieving high economic growth. Because banks play an important part in the allocation of resources in a developing economy, and because they play the most important role in cross-border financial operations, the banking system will undoubtedly constitute a leading actor in all processes of economic integration, in other words, economic integration cannot be achieved with a weak banking system.

Similarly, economic integration cannot be fully achieved unless the concerned parties harmonize their economic and financial policies in order to secure large mobilizations of labour, goods and capital to support investments throughout the bloc. Under such circumstances, financial institutions, and especially banking institutions, become the centre of economic integration. Under ordinary conditions, the majority of payments and international transfers are made through the banking system. Hence, under an economic integration scheme, the role of these institutions becomes even more important for the success of the economic bloc.

International economic transactions depend highly on the capacity from the economic agents to regulate them, regardless of existing barriers among nations. Moreover, direct investment projects and international financing are not feasible in the absence of mechanisms that assist international capital movements.

In their long-established role as financial intermediaries, banks expedite the mobilization of funds among partners of an economic bloc, and promote fluid and effective operations. They assist in this objective and facilitate an effective regulation of trade and financial operations among economic agents from the bloc.

Banks can be justly considered as the most important link in the realization of international commercial and trade transactions. Since only in the long run is a monetary union possible, member countries must maintain their own currencies, in this context, financial institutions become even more important since economic exchange among the member countries includes constant exchange rate operations.

Banks contribute to financial integration within a bloc through their traditional activities as borrowers and lenders. They continuously create, to the benefit of their

clients, new techniques and instruments to increase their competitiveness at the local markets, as well as to achieve an international competitive edge.

Finally, it is worth mentioning that an analysis of the role of financial institutions in a process of economic integration involves three important issues, taking into account that financial activity should contribute to enhance economic growth of the bloc.

One concerns the efficiency and competitiveness of financial institutions of each country member of the bloc. Indeed, this is an important motivation for economic integration. It is for this reason that various international economic agreements include important chapters about their financial institutions. Founded on clear financial provisions, it is expected that economic integration would ideally open up free spaces where financial institutions of the member countries can have access to the financial markets from other members of the group, i.e., entry without undue restrictions. In this context, the possibility of greater efficiency from financial institutions is obvious, considering the fact that there are conditions for greater competition in the new financially-integrated market. Financial institutions must therefore prepare themselves for the challenges brought about by economic integration, training their employees, strengthening their financial position, and marching the competitive standards of their neighbors.

A second issue deals with the response of banking institutions to financial liberalization and deregulation, and economic integration. Due to the fact that banks can increase lending more easily, solvency problems could take place. In this respect, it is imperative to identify problems of bank solvency and offer alternatives to regulate bank operations and avoid bank runs.

Finally, a third issue pertains to the costs of deposit insurance programs. Full implicit or explicit government guarantees are the extreme negative case that promotes poor bank management. It is therefore important to study risks associated with a bank and its value in the context of financial liberalization and integration.

### **Risks of Financial integration and Globalization**

Although economic integration should have positive impacts on the economies of the participating countries, it also involves risks that must be correctly identified to control them effectively and prevent ill effects. The most important risk associated with financial integration concerns increments in the volatility of financial operations, which in turn could lead to insolvency problems and even bankruptcy of financial institutions, as well as severe financial shocks that lead to a fully-fledged economic crisis. Greater volatility can result from both local and international causes,

On the domestic side, volatility in financial operations can increase due to unattended economic disequilibria or changes in the political scenario. Since integration policies are frequently implemented along with financial deregulation and liberalization policies, the roots of financial volatility would be associated with the lack of appropriate responses from financial institutions and entrepreneurs to the new economic environment characterized by competition and expanded economic activity covering the space of the bloc. Higher competitiveness could lead to greater uncertainty in prices, profits, and payments of liabilities. Similarly, economic integration can lead to excessive corporate and bank financing with foreign resources. In turn, expanded economic activity can create over-optimistic

attitudes towards future levels of trade and investments. These attitudes might overshadow the breadth of existing disequilibria, overheat the economy, and lead to abrupt changes in financial prices when expectations adjust to more realistic levels.

On the international level, volatility in financial operations in the developing nations can increase as a result of downfalls in economic activity of major economic partners, or industrialized countries in general, or as a result of profound international portfolio adjustments and capital reversals made by large institutional investors in response to financial cracks at some developed or developing financial markets, in the first case, the impacts of a downturn in economic activity in a developed partner would lead to extreme volatility in financial operations of developing partners. The impact could be magnified if integration has been built on an asymmetric basis. Moreover, as a result of financial integration, smaller nations would be less capable of implementing adjusting policies on their own. In the second case, the transmission effects of financial crisis, local or from a group of countries, has been identified as the contagion effect. They result from worldwide portfolio adjustments made by international institutional investors to overcome downfalls in a market.

In the case of nations with soft currencies, volatility in financial operations can also increase due to unstable exchange rates, expectations of a local devaluation of an overvalued local currency, and ultimately from sharp devaluations which affect the local financial markets and institutions. Moreover, recent studies confirm that currency crisis and banking crisis go hand in hand. The usual sequence is: 1) weak policy-making, which undermines the external sector and the value of the local currency coupled with a marked fragility of the financial system, particularly large levels of non-performing loans and excessive banking liabilities in hard currencies<sup>5</sup>; 2) currency crisis, which fuels the insolvency problems of the banking system, which could even lead to bank runs and a systemic crisis. A twin financial crisis (currency and banking crisis) then ensues and leads to a fully-fledged crisis of the economy (Kaminsky and Reinhart, 1999). In developing and transition economies with emerging capital markets, a triple crisis might take place: the currency crisis leads to massive capital withdrawals by foreign investors leading to a securities market crash. Each of the crises of these triple phenomena feed on each other and might even become contagion mechanisms to initiate crisis in other countries or regions.

### **Government Guarantees, Development and Integration**

To protect all participants in the banking system, governments often offer full guarantee to all banks. This shifts private risk associated with bank liabilities to the government (World Bank, 1997), specifically to all taxpayers. These guarantees protect the payments system, prevent bank runs, and protect depositors against losses. However, empirical evidence shows that these guarantees promote poor and ambitious bank management. Strained by increased competition, resulting from financial liberalization and deregulation policies, and distressed by the entry of foreign intermediaries to the local market which lowers the franchise value of banks, local bank managers are induced to lend haphazardly, to clients willing to pay high interest rates, but pursuing very risky projects which undermines their capacity to pay. In short, these type of bank managers gamble on future economic

growth. This phenomenon, rooted in asymmetric information problems and known as 'adverse selection' and 'moral hazard,' is made possible by the guarantee which operates in a similar way to a put option (King, 1992). If the value of the bank's assets falls below the value of its liabilities, the guarantee makes up the difference. An increase in the riskiness of the asset portfolio increases the value of the guarantee to bank owners and executives, for greater risks increase the potential for large up-side profits, while the government guarantee insures depositors against downside losses (Ibid). Banks can therefore bear greater risks, searching for big gains, without worrying about possible losses. This situation is summarized in Figure 19.1.

This becomes a source of financial instability since banks try to increase profits without proper measuring of risk undertaken. Indeed, credit practices weaken. Credit analysis is incomplete and poor since banks rather attempt to maximize the value of the guarantees.

As a corollary of the previous point, it must be stressed that adverse selection and moral hazard induce large increments in lending rates, repressing savings rates leading to large interest rate spreads, enforced to achieve quick gains. However, these policies lead to large increases in bad loans. As a result, the balance sheet statement and the income statement, show sharp weaknesses; financial performance ratios derived from those statements show a clear trend to deterioration. If this situation is sustained for too long, banks will try to solve their problems by falling into a vicious circle of further increases in lending rates and repression of savings rates.

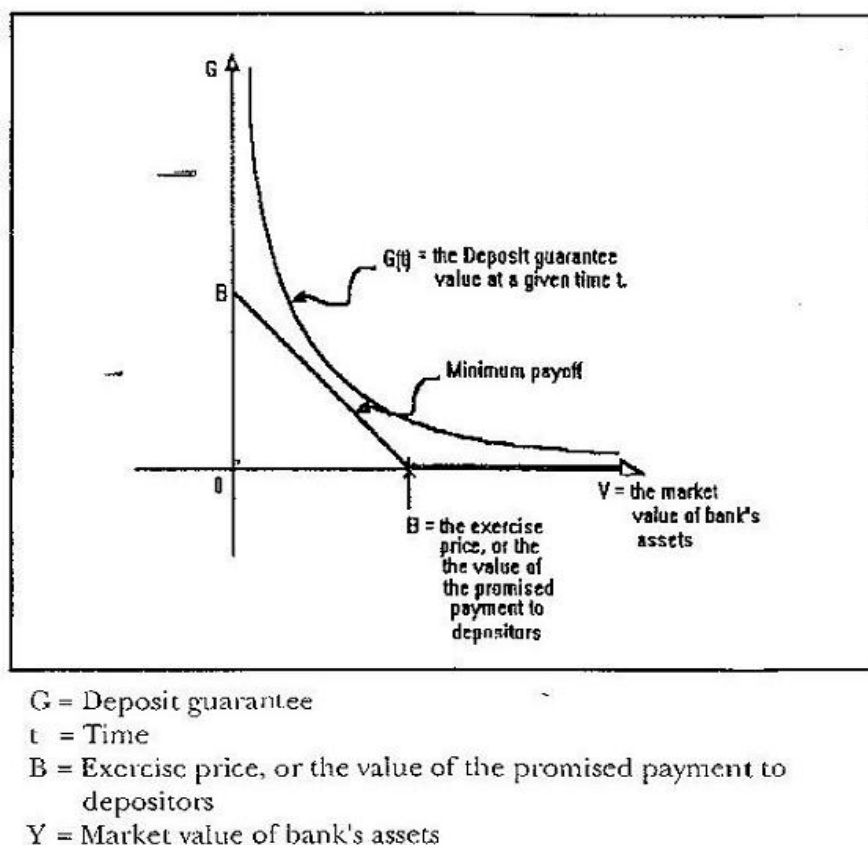
As a corollary of the previous point, it must be stressed that adverse selection and moral hazard induce large increments in lending rates, repressing savings rates leading to large interest rate spreads, enforced to achieve quick gains. However, these policies lead to large increases in bad loans. As a result, the balance sheet statement and the income statement, show sharp weaknesses; financial performance ratios derived from those statements show a clear trend to deterioration.

If this situation is sustained for too long, banks will try to solve their problems by falling into a vicious circle of further increases in lending rates and repression of savings rates.

Moral hazard also leads banks to deviate large amounts of resources to speculative investments at the secondary money and capital markets, in lieu of supporting lending activities related to real investments. Finally, moral hazard can also lead to illegal actions by some managers and executives. They access their bank's financial resources to purchase property registered in their name, transfer money to personal accounts at offshore banks, etc.

Implementing governmental guarantees usually enforce large rescue programmes which, although created to protect users of the payments system, reward poor bank management and socialize costs. It also means that strengthening the banking system capital and improving its efficiency to a great extent depends on

wide and complex mergers, as well as on increased participation of foreign capital, even to a 100 per cent level, in the local insolvent institutions. This could lead, in some countries, to an undesirable denationalization of the payments system and some loss of autonomous monetary policy-making. This is particularly the case with developing countries.



**FIGURE 19.1:** *Deposit Insurance as a Put Option*

Moral hazard also becomes a source of financial fragility because

In short, financial liberalization, deregulation, and economic integration could encourage banks toward excessive risk-taking, weakening significantly the banking system. As a result, governments might be forced to implement large long-range rescue programmes. Consequently, economic and financial integration will be slowed down, while development would be restrained for many years.

It is therefore important to enforce policies and regulations that diminish moral hazard. An important part of these policies and regulations must include establishing a system of no it-governmental deposit guarantees.

## **Conclusion**

Financial assets and financial institutions are important factors in the allocation of scarce resources. Financial intermediaries promote efficient mobilization of surplus funds from saving units to deficit spending investing units. The essential fact is that financial structure and hence financial intermediation do matter in economic growth. Financial intermediaries have an important role in output

because they help to: (1) increase savings and optimize the portfolio holdings of ultimate lenders; (2) optimize their own portfolio holdings by proper risk—return management; and, (3) make funds available to efficient deficit spending" in vesting units. In short, financial intermediation involves a transformation of the funds process - a process which, as Goldsmith (1969) puts it, is economically though not technically equivalent to the transformation taking place in the production of commodities and services (Goldsmith, 1968, p. 26).

Economic integration leads to considerable benefits for each member country and the integrated unit as a whole. Benefits arise from increased investments, open and more efficient patterns of corporate governance and management, and greater competition and efficiency of the financial system, particularly banking institutions. All these benefits accelerate economic growth.

In short, economic integration can be seen as an important engine for achieving high economic growth. Because banks play an important part in the allocation of resources in developing economies, and because they play the most important role in cross-border financial operations, the banking system constitutes a leading actor in economic integration.

However, economic integration, like any other economic activity, involves risk. The most important risk associated with financial integration concerns increments in the volatility of financial operations, which could lead to severe insolvency problems and even bankruptcy of financial institutions, as well as severe financial shocks that lead to fully-fledged economic crisis. Greater volatility can result from both local and international causes. In this respect, an important source of increased instability in the local financial markets is poor banking practices due to moral hazard. Because liberalization eases credit granting by banks, and particularly because government guarantees to deposits are ample, and because economic integration creates over-optimistic expectations, credit practices weaken. Hence, bank assets tend to increase more than liabilities. Furthermore, bad loans increase beyond sustainable levels. As a result the government must intervene with massive rescue plans which slow down integration and restrain economic growth for long periods.

In conclusion, to promote economic development, taking full advantage of the benefits brought about by economic integration, it is important to strengthen the banking system.



## References

- ALLEN, F. and GALE, D. (2000) Optimal currency crisis, *Carnegie-Rochester Series in Public Policy*, forthcoming. BKNNET, R. L. (1965) *The Financial Sector and Economic Development: The Mexican Case*, Johns Hopkins, Baltimore.
- BERNANKE, B. S. (1983) Non-monetary effects of the financial crisis in the propagation of the Great Depression, *American Economic Review* Vol. 73 (June), pp 257-276.
- BLEJER, M. I. and SKREB, M. (eds.) (1999) *Financial Sector Transformation. Lessons from Economics in Transition*, Cambridge University Press, New York.
- CABELLO, A. (1999) *Globalization y Liberalización Financieras y Bolsa Mexicana de Valores. Del Auge a la Crisis*, Plaza y Valdés, Mexico, DF.
- DLVMOND, D. (1984) Financial intermediation and delegated monitoring, *Review of Economic Studies*, Vol. 51 (Autumn), pp. 393-414.
- FAMA, E. (1984) The information in the term structure, *Journal of Financial Economics*, Vol. 13 (December), pp. 509-528.
- FRY, M. (1988) *Money, Interest and Banking in Economic Development*, Johns Hopkins, Baltimore.
- FRY, M. (1989) Financial development: Theories and recent experience, *Oxford Review of Economic Policy*, Vol. 5, No. 4, pp. 13—28.
- GAI .BIS, V. (1977) Financial intermediation and economic growth in less developed countries: A theoretical approach, in P.C. AYRK (ed.), *Finance in Developing Countries*, Frank Cass, London.
- GOLDSMITH, R. W. (1968) *Financial Institutions*, Randa House, New York.
- GOLDSMITH, R. W. (1969) *Financial Structure and Development*, Yale University Press, New York.
- GUPTA, K. (1984) *Finance and Growth in Developing Countries*, Croom Helm, London.
- GURJLEYJ. G. and SHAW, E. S. (1960) *Money in a Theory of Finance*, Brookings Institution, Washington DC.
- IVAN OVA, A. (1998) *Los Intermediarios Financieros no Bancarios y el Crecimiento Económico. El Caso de México*, Doctoral Thesis, Universidad Nacional Autónoma de México.
- JAMES, C. (1987) Some evidence on the uniqueness of bank loans ; *Journal of Financial Economics*. Vol. 19, No. 2, pp. 217-236.
- KAMINSKY, G. L. and RIUNHART, C. M. (1999) The twin crisis: The causes of banking and balance of payments crisis, *American Economic Review*, June, pp. 473-500.
- KJNG, K. K. (1992) Deposit insurance as a put option: Alternative approaches to modeling regulatory forbearance, *Board of Governors of the Federal Reserve System*.
- LEVINE, R. (1997) Financial development and economic growth, *Journal of Economic Literature*, Vol. XXXV, No. 2, pp. 688-726.
- LOPEZ OBRADOR, A. M. (1999) *Fobaprv: Expediente Abierto*, Grijalbo, Mexico, DF.
- McKJNNON, R. 1. (1973) *Money and Capital in Economic Development*, Brookings Institution, Washington DC.
- MOSKOW, M. H. (2000) *Disruption in Global Financial Markets: The Role of Public Policy*, Paper presented at the Global Finance Conference, April 21.
- ORTIZ, E. ( 1993) Emerging markets and economic development, in K. FATEMI and D. SALVATORL (eds.), *Foreign Exchange issues. Capital Markets and International Banking in the 1990s*, Taylor and Francis, Washington DC.
- ORTIZ, E. (1995) Take-off into development and emerging capital markets: Stages of financial development and equity financing, in H. R GRAY and S. C. RICHARD (eds.), *International Finance in the New World Order*, Pergamon, New York.
- PATRICK, H. T. (1966) Financial development and economic growth in underdeveloped countries, *Development and Cxdtural Change*, Vol. 14, No. 2, pp. 77-97.
- REISEN, H. (1996) Managing volatile capital inflows: The experience of the 1990s, *Asian Development Review*, Vol. 14, pp. 72—96.

- SHAW, E. S. (1973)** *Financial Deepening in Economic Development*, **Oxford University Press, New York.**
- STUDART, R. (1998)** Políticas financieras y crecimiento en el contesto de desarrollo: Lecciones derivadas de América Latina y del Sudoeste Asiático en los Años Ochenta, *Investigación Económica*, Vol. LVII, No. 1, pp. 15-42.
- TOBIN, J. (1965)** Money and economic growth, *Econometrica*, Vol. 33, No. 4, pp. 671— 684.
- WORLD BANK, The (1997)** *Private Capital Flows to Developing Countries, the Road to Financial Integration*, **Oxford University Press, Oxford**

## Notes

The authors acknowledge research support from the Research Fund for Studies of the North American Region, created by El Colegio de México, Universidad Nacional Autónoma de México, Centro de Investigación y Docencia Económicas and El Colegio de la Frontera Norte.

1. This work stresses the case of developing nations. See Blejer and Skreb (1999) for recent and excellent coverage of financial reforms issues in transition economies.
2. Costs of the 1995 Mexican banking crisis have been recently estimated as 20— 25 per cent of GDP (Lopez Obrador, 1999); costs of the 1997 Asian countries crisis vary between 20 and 65 per cent of GDP (Moskow, 2000).
3. Levine's (1997) paper lists, in the References section, the most important thinkers of development finance. Other useful bibliographies can be found in Ortiz (1995) y Cabello (1999), and Ivanova (1998).
4. Equity markets correspond to the last stage of financial development. See: Ortiz (1995).
5. Central bank and commercial bank borrowing impacts on currency crises are modeled in Allen and Gale (2000),