



IMPACT OF FINANCIAL MARKETS GLOBALIZATION ON INDIAN ECONOMIC GROWTH

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ABSTRACT

India' is the new global buzzword. The economy growing at a phenomenal rate, combined with a flourishing democracy is making people sit up and take notice across the world. Yet, it is at cross-roads today. It is far from reaching its true potential. Several social, political and economic factors need to be tackled for sustaining a high rate of growth, as well as to make this growth inclusive. It is concluded that in addition to skills development, there is need for ancillary support such as employment services, career guidance, job placement services and back to work programs to bridge the distance between training and productive employment. These cannot be provided by government alone and there is need for partnerships between the private sector and service providers with training institutions.

INTRODUCTION

Financial markets around the world have become increasingly interconnected. Financial globalization has brought considerable benefits to national economies and to investors and savers, but it has also changed the structure of markets, creating new risks and challenges for market participants and policymakers.

Forces driving financial globalization

There are four main factors.

1. Advances in information and computer technologies
2. The globalization of national economies.
3. The liberalization of national financial and capital markets.
4. Competition among the providers of intermediary services.



The various financial institutions including banks and institutional investors have expanded their activities geographically. In this process, they acted as an intermediary to channel funds from lenders to borrowers across national borders and the more mature securities markets have gained a clear cross-border orientation. This resulted in an augmentation of the range of borrowing and lending possibilities available to economic agents throughout the world. In particular, there was a marked expansion of the range of financial possibilities available for financing current account deficits and recycling current account surpluses. Even though it includes issues such as the vulnerability of the international financial system to crises or the limited room for man oeuvre which is available for economic policy pursuing specific objectives at the national level. The aim of the study is in the context of recent globalised Financial markets wave to examine various indicators of globalization and, after reviewing the evidence, try and identify an operational definition of the concept of globalization, which will be useful in order to discuss the implications of the phenomenon for economic growth and also discuss the benefits and risks associated with the globalization of financial markets and the role that economic policy can play in this context.

OVERVIEW OF LITERATURE:

Financial market innovation has contributed to enhanced risk management in the financial system. By distributing risks across a broad universe of investors, financial innovations such as credit derivatives, structured finance, and securitization techniques have helped to reduce the concentration of risk among financial intermediaries. Increased linkages across different markets may provide access to liquidity in other markets in case of a single dealer failure, as appears to be the case in the over-the-counter (OTC) market for U.S. dollar interest rate options (Parkinson, Gibson, Mosser, Walter, and LaTorre, 2005). Also, bilateral asset holdings and the corresponding geographic diversification of risk have increased due to the gradual harmonization of regulatory regimes (Vlachos, 2004). The risk transfer market continues to evolve rapidly, attracting investors other than financial institutions. For instance, in recent years credit derivatives have enabled the transfer of credit risk to insurance companies (IAIS, 2003; BCBS, 2004; IMF, 2006b), a development deemed beneficial for financial stability (Greenspan, 2005). In the credit risk transfer market, there are two recent emerging trends worth noting: (i) the transfer of insurance risk to financial markets through securitized tranches; and (ii) the increased use of credit default swaps by insurers to hedge their corporate credit exposure, as insurers continue to adopt credit risk management techniques used in banking (Wolcott, 2006). Insurers, however, continued to be net sellers of credit protection through credit derivatives due to their search for yield enhancement (Fitch, 2006).

The globalization of financial markets may have also contributed to reduced market volatility due to increased liquidity, a plausible stabilizing role played by institutional investors, more efficient price discovery, and the availability of more instruments for corporations to manage



the risks in their balance sheets (BIS, 2006). Evidence indicates that the introduction of derivatives either has no impact on the volatility of the underlying assets or leads to reduced volatility (Conrad, 1989; Bollen, 1998; Cohen, 1999). Financial globalization and financial innovation also appear to have had a dampening effect on macroeconomic volatility (Kose, Prasad, and Terrones, 2003; and Dynan, Elmendorf, and Sichel, 2006).

Price discovery is also aided by financial innovation. For instance, the development of the credit derivatives market has fostered further price discovery in the corporate bond market which was until recently, dominated by a narrow investor base (Wallenstein, 2000). The relatively low funding costs in the credit derivatives market vis-à-vis the bond market has attracted a diverse group of investors and speculators. Empirical evidence suggests that such a diverse investor base helps price discovery to flow from the credit derivatives market to the bond market as arbitrageurs profit from relative value strategies in both markets (Blanco, Brennan, and Marsh, 2005; Chan-Lau and Kim, 2005).

The continuing growth of the credit derivatives markets has also facilitated extracting market views on the default risk on individual companies and sovereign countries (Marsh, 2002; Chan-Lau, 2003; Zhang, 2003; Das and Hanouna, 2006), systemic risk in the corporate sector (Chan-Lau and Lu, 2006), and to rank the relative exposure of financial institutions to the credit risk transfer market (Chan-Lau and Ong, 2007). These and other measures of default risk from credit derivatives are useful for monitoring risks in the financial system and facilitate the financial surveillance work of central banks and multilateral financial institutions.

While financial innovation has brought about a number of benefits, it could make systemic crises more likely (Hendricks, Kambhu, and Mosser, 2006). Historical evidence suggests that financial markets are intrinsically fragile (Schnabel and Shin, 2004; Kindleberger, 2005). Furthermore, the increased importance of non-bank financial intermediation vis-à-vis banking intermediation could lead to less frequent but more severe financial crises as financial intermediaries are forced to liquidate their assets at fire-sale prices (Gai, Kapadia, and Millard, 2006).

Potential mechanism that could lead to feedback trading and cause one-sided markets is the increased adoption of similar market-based risk management models, such as Value-at-Risk (VaR), by large complex financial institutions (LCFIs). VaR systems could induce institutions with relatively homogeneous portfolios and trading strategies to undertake take similar actions during periods of turmoil that in turn, could create downward pressure on prices (Basak and Shapiro, 2001). Furthermore, market-based risk management systems could mislead their users into a false sense of security. The calibration of market-based risk management systems relies heavily on past historical data, and so the systems may not be able to account for nor forecast neither structural breaks in financial markets nor rapidly



changing conditions in the operating environment. Countering these arguments, it has been argued that the broadening and diversification of the investor base could help to bring in additional pools of liquidity and “risk capital” that could help stabilize markets. Arguably, such diversification may be more illusory than real if most market participants are required to use similar market-based risk management models, a point that has been strongly argued by Persaud (2003).

Even if the diversification benefits of new “risk capital” are real, capital constrained arbitrageurs may not be able to arbitrage away non-fundamental price deviations (Shleifer and Vishny, 1997; Liu and Longstaff, 2004). For instance, convergence trading can smooth shocks in the interest rate swap market during normal periods. However, an unexpected large negative shock could force traders to close out their positions prematurely, leading to a fall in liquidity and repo volumes (Kambhu, 2006).

FINANCIAL GLOBALIZATION:

Financial globalization and financial integration are, in principle, different concepts. Financial globalization is an aggregate concept that refers to increasing global linkages created 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 increasing financial integration on average. The distinction between de jure financial integration, which is associated with policies on capital account liberalization, and actual capital flows. For example, indicator measures of the extent of government restrictions on capital flows across national borders have been used extensively in the literature. On the one hand, using this measure, many countries in Latin America would be considered closed to financial flows. On the other hand, the volume of capital actually crossing the borders of these countries has been large relative to the average volume of such flows for all developing countries. Therefore, on a de facto basis, these Latin American countries are quite open to global financial flows. By contrast, some countries in Africa have few formal restrictions on capital account transactions but have not experienced significant capital flows.

IMPACT OF FINANCIAL GLOBALISATION:

The recent era of financial globalization that has a surge in capital flows among industrial countries and, more notably, between industrial and developing countries. Although capital inflows have been associated with high growth rates in some developing countries, a number of them have also experienced periodic collapses in growth rates and significant financial crises that have had substantial macroeconomic and social costs. As a result, an intense debate has emerged in both academic and policy circles on the impact of financial integration on developing economies.



General principles emerge from the study about how countries can increase the benefits from and control the risks of globalization. In particular, the quality of domestic institutions appears to play a major role. A growing body of evidence suggests that it has a quantitatively important impact on a country's ability to attract foreign direct investment and on its vulnerability to crises. Although different measures of institutional quality are no doubt correlated, there is accumulating evidence of the benefits of robust legal and supervisory frameworks, low levels of corruption, a high degree of transparency, and good corporate governance.

Features of global capital flows:

First, the volume of cross-border capital flows has risen substantially in the last decade. There has been not only a much greater volume of flows among industrial countries but also a surge in flows from industrial to developing countries. Second, this surge in international capital flows to developing countries is the outcome of both "pull" and "push" factors. Pull factors arise from changes in policies and other aspects of opening up by developing countries. These include liberalization of capital accounts and domestic stock markets, and large-scale privatization programs. Push factors include business-cycle conditions and macroeconomic policy changes in industrial countries. From a longer-term perspective, this latter set of factors includes the rise in the importance of institutional investors in industrial countries and demographic changes (for example, the relative aging of the population in industrial countries). The importance of these factors suggests that notwithstanding temporary interruptions during crisis periods or global business-cycle downturns, the past twenty years have been characterized by secular pressures for rising global capital flows to the developing world.

Another important feature of international capital flows is that the components of these flows differ markedly in terms of volatility. In particular, bank borrowing and portfolio flows are substantially more volatile than foreign direct investment. Although accurate classification of capital flows is not easy, evidence suggests that the composition of capital flows can have a significant influence on a country's vulnerability to financial crises.

Role of Institutions and Governance in Effects of Globalization

Although it is difficult to find a simple relationship between financial globalization and growth or consumption volatility, there is some evidence of nonlinearities or threshold effects in the relationship. Financial globalization, in combination with good macroeconomic policies and good domestic governance, appears to be conducive to growth. For example, countries with good human capital and governance tend to do better at attracting foreign direct investment (FDI), which is especially conducive to growth. More



specifically, recent research shows that corruption has a strongly negative effect on FDI inflows. Similarly, transparency of government operations, which is another dimension of good governance, has a strong positive effect on investment inflows from international mutual funds. In this context it is discussed how the ability of a developing country to derive benefits from financial globalization and its relative vulnerability to the volatility of international capital flows can be significantly affected by the quality of both its macroeconomic framework and its institutions.

RISKS AND RETURNS OF FINANCIAL GLOBALISATION:

The potential benefits of financial globalization will likely lead to a more financially interconnected world. 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 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.

KEY TRENDS AND ITS IMPLICATIONS:

A fully integrated market is one where economic agents face a single set of rules, have equal access and are treated equally. By implication, the law of one price would hold in such a fully integrated market, ie risk-adjusted real returns on assets with the same maturity and other characteristics would be equal. This process is only partly driven by governmental action. Governments can in principle lift legal restrictions on capital movements overnight (although it would in most cases not be advisable to do so). They could possibly also move relatively quickly to harmonize diverse rules, regulations and practices that are impediments to cross-border financial integration, although in practice this is often a drawn out process and differences in legal systems and business practices tend to be significant impediments to free flow of capital. Furthermore, legal freedom to practice financial innovation could be expected over time to reduce frictions to the flow of capital. The abolition of government-imposed restrictions to the flow of capital will thus not instantaneously result in the law of one price holding across countries. It will at least require several years of a market-driven integration process and even then, the theoretical limiting case might never be reached. The potential implications of cross-border financial integration provide us with candidate measures of its ongoing process. Some of these implications are:

- Covered interest parity should hold.
- Stronger co-movement of asset returns across countries. Greater scope for risk sharing

across countries through output and/or consumption smoothing.

Greater potential to decouple domestic saving and investment. These implications provide several potential measures of ongoing cross-border financial integration. Below is taxonomy of tendencies that would be consistent with a higher degree of cross-border financial integration:

1. **Legal or regulatory measures:** Lower level of legal restrictions on capital flows. Lower level of other legal and regulatory-based impediments to cross-border financial integration, including taxation and the design of monetary instruments.

2. **Price-based measures:** Covered interest rate parity holds. Increased co-movement of asset returns.

3. **Quantity-based measures:** Higher level of gross cross-border capital flows.

- Higher level of cross-border assets and liabilities.
- Reduced home bias in domestic portfolios.
- Lower correlations of domestic saving and investment.
- Lower correlations of domestic consumption and GDP.

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