

Rethinking Financial Globalisation in Crisis Aftermath

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History tells us time and time again that finance does matter for economic development. The way the current global financial crisis turns out has brought to the forefront the important role that finance play.

The new paradigm of finance or the so-called “financial globalization” began in earnest in the mid-1980s, with improvements in information technology and the removal of barriers to the free flow of capital across countries. This process was spurred by the anticipated benefits that cross-border flows would bring in more efficient global allocation of financial resources and international risk sharing. The main idea was that these benefits would be significant, especially for developing countries that tend to be capital-scarce and have more volatile economic growth. Financial globalization was packaged into a “to-do” list of liberalization policies most actively prescribed by International Financial Institutions (IFI’s) and the rich industrial nations as the cure for the economic illness facing developing countries.

Today, after almost three decades of experiment, all is not well in the liberalization camp. With the surge in financial flows, we have witnessed many incidences of currency and financial crises around the world, both in developing and developed countries alike. These developments have led to many stimulating debates among both academics and practitioners on the costs and benefits of financial globalization.

Last month the discussion took place in Bangkok at the Bank of Thailand’s International Symposium where world-class academics and practitioners got together to present their works under the theme of “Financial Globalization and Emerging Market Economies.”

The views expressed in this forum provide many interesting insights. One of the key points from Professor Dani Rodrik ’s keynote address is that the theoretical benefits of financial globalization essentially presume a first-best setting (perfect market) while in fact financial system operates in a second-best (imperfect) environment. For this reason, two types of advice emerge for policy makers.

The first type of advice comes from the first-best economists who think that through appropriate set of prudential policies and reforms market imperfection can be taken care of and the financial globalization process can still be enhanced. The second type of advice come from the second-best economists who acknowledge that market imperfection is here to stay and are in favour of introducing some kind of capital controls or the imposition of frictions such as “Tobin taxes” or sand in the wheels of international finance.

The meeting concludes with the hope that there will be significant progress in terms of reforming the international financial architecture and that both the first and second-best kind of advice are taken into account. The second-best economists need to ask themselves whether there will be instances when the remedy of direct intervention in the international capital flows is going to make things worse because of potential problems created by corruption and other instability associated with such interventions. The first-best economists need to ask themselves on how realistic it is to assume that we can continue to undertake the complementary reforms that are needed to make financial globalization work when the agenda is large and will not be completed overnight.

For more details of the papers and presentations of this symposium, please visit www.bot.or.th/English/EconomicConditions/Semina/Pages/Intersym2008.aspx

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