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The Evidence and
**Impact of Financial
Globalization**

Edited by
Gerard Caprio Jr.



THE EVIDENCE AND IMPACT OF FINANCIAL GLOBALIZATION

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Elsevier
32 Jamestown Road, London NW1 7BY, UK
225 Wyman Street, Waltham, MA 02451, USA
525 B Street, Suite 1800, San Diego, CA 92101-4495, USA

First edition 2013

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Chapter 38, Definitions and Types of Financial Contagion
Published by Elsevier Inc.

Chapter 8, Migrant Remittances and Development
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Chapter 28, Financial Globalization and Monetary Policy
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Chapter 42, US Stock Market Crisis of 1987
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British Library Cataloguing-in-Publication Data

A catalogue record for this book is available from the British Library

Library of Congress Cataloging-in-Publication Data

A catalog record for this book is available from the Library of Congress

ISBN: 978-0-123-97874-5

For information on all Academic Press publications
visit our website at elsevierdirect.com

Typeset by SPi Global
www.spi-global.com

Printed and bound in United States of America

12 13 14 15 16 10 9 8 7 6 5 4 3 2 1

Editorial: Gemma Mattingley
Production: Karen East and Kirsty Halterman

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Preface

Although finance has been a cross-border business for centuries, there are many senses in which the world is becoming more globalized financially. To be sure, early banks carried out transactions to settle imbalances at international trade fairs in the Middle Ages, but the vast swath of society at that time lived untouched by or unconcerned with the financial world outside their village and certainly outside their region. Their world abounded with risks, yet these risks were largely of the type from which their ability to achieve any kind of protection was limited. Indeed, risk was a term that if understood at all would have very different connotations than it does today. Probabilistic thinking was not yet known, and fate or 'God's will' was the more operative expression.

Finance, even in basic settings, performs the same functions throughout history as those identified by Levine (1997): mobilize savings, allocate resources, monitor investments, provide payments, and mitigate risk.¹ However, both the demand for and the ability of financial systems to provide these services have expanded and evolved in countless directions. Just as money long ago ceased to entail the burden of transporting precious metals (notwithstanding the desire of Congressman Ron Paul, a US presidential candidate as of this writing, to do away with central banks and return to a world of money backed by gold), more recently even international payments are made by electronic transfer. Residents of the world can now travel to other countries carrying only a piece of plastic to make payments, and likely soon will be dispensing with plastic, using a chip built into their cell phones. Many workers in middle-income countries today, and most in higher income economies, have bank accounts or more likely mutual or pension funds with investments outside their home country, though some may not be well aware of their exposure. Just as pensions deal with a risk previously unrecognized – the period after the working stage of life used to be death, and later in time the exceptionally brief interlude of care was provided by families – many risks covered by financial instruments today are relatively recent in being perceived, let alone addressed by finance.

The many advances in financial services come with a cost, including the cost of crises. Certainly, crises have been important as long as modern banks have existed – from the failure of banks in northern Italy (including the Ricciardi, the Bardi, and the Peruzzi banks) to the ongoing Euro crisis and the impairment of bank balance sheets that of this writing still is officially minimized. The persistence of crises – which Kindleberger once dubbed 'A Hardy Perennial' – might seem puzzling. Why do societies not learn and protect themselves and/or regulate the financial system better? The answer of course is that finance arises due to information asymmetries, without which there would not only be no crises but also no return for financial intermediaries.

Notwithstanding these many constants, the shape of finance has changed markedly in recent decades since the era of extensive domestic and international controls in the aftermath of World War II, when much of the world lived in a period in which the returns on many assets were controlled, instruments not allowed, credit guidance was directly or subtly provided by government, and, in socialist economies, mandated almost entirely by the hand of the state. Now for the first time in history, the residents of virtually all countries can participate in the global financial system, though many, especially in the lowest income countries, remain locally based. But controls have been lifted, capital flows freely across many borders, and financial innovations occur at a rapid pace, even if not all of these innovations contribute to society's welfare. And efforts to control the financial system understandably advance as the industry itself changes.

It is into this situation in the development of global finance that the present effort comes. Three volumes – the *Handbook of Key Global Financial Markets, Institutions, and Infrastructure*; the *Handbook of Safeguarding Global Financial Stability: Political, Social, Cultural, and Economic Theories and Models*; and *The Evidence and Impact of Financial Globalization* – have been put together online and in print to advance our understanding of the origins, requirements, and consequences of financial globalization. The chapters herein share a common overarching goal:

¹ Levine, R., 1997. Financial development and economic growth: views and agenda. *Journal of Economic Literature* 35 (2), 688–726.

to describe the many issues related to financial globalization. The first volume looks at the historical roots of financial globalization, as this is not the first time financial systems have trod this path, and likely will not be the last. Given the technology of today, it then turns to look at the 'plumbing' that underlies a healthy financial system, both at the national and global level, including that which supports the ever-changing panoply of new instruments. Financial infrastructure shapes financial systems as surely as any regulator. Thus, some developing countries are at present just seeing the birth of a private bond market, which often is the last part of the system to develop as a result of the demands that it places on the legal system and on information.

The second volume examines the political economy of finance. Since its inception, finance has been intimately linked with government. Just as goldsmiths and other early bankers were discovering that not all depositors demanded their money back every day, so that some funds could be profitably deployed, kings were desperately seeking funding for soaring armament expenditures, and a relationship that continues to this day was born. Once the sovereign's security was assured, other governmental functions needed finance, as did the many projects, useful and not, of the sovereign's supporters. Bankers' financial clout quickly translated to political power, and the difficulty of getting financial regulation that works, in addition to being linked to the difficulty of the job, has also been linked to the influence of the industry. Thus, the volume also turns to a discussion of what is meant by financial stability, of attempts to safeguard the stability of the global financial system, and of the many international bodies that are involved in the effort and how they might contribute to this goal. Finally, this volume also looks at how various theories of financial globalization evolved with the developments in the markets. Interestingly, debates on flexible versus fixed exchange rates during the 1960s completely missed the story of what happened once the Bretton Woods system ended.² As tumultuous as the 'real world' has been with more integrated financial markets and flexible exchange rates, one senses that the theoretical literature is evolving significantly as well.

Last, but certainly not least, is the final volume that looks at the expanding literature on empirical research regarding the forces behind and the impact of financial globalization, how it has affected policies, and the crises associated with globalized finance, which are transmitted through many channels. The scope of the issues covered in this volume alone testifies to the complexity of the phenomenon.

In this investigation of financial globalization, it is worthwhile to remember that progress has not been linear. It was less than 90 years ago that Keynes could write that

The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their early delivery upon his doorstep; he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world, and share, without exertion or even trouble, in their prospective fruits and advantages; or he could decide to couple the security of his fortunes with the good faith of the townspeople of any substantial municipality in any continent that fancy or information might recommend. He could secure forthwith, if he wished it, cheap and comfortable means of transit to any country or climate without passport or other formality, could dispatch his servant to the neighboring office of a bank for such supply of the precious metals as might seem convenient, and could then proceed abroad to foreign quarters, without knowledge of their religion, language, or customs, bearing coined wealth upon his person, and would consider himself greatly aggrieved and much surprised at the least interference. But, most important of all, he regarded this state of affairs as normal, certain, and permanent, except in the direction of further improvement, and any deviation from it as aberrant, scandalous, and avoidable.³

Keynes' last sentence ranks among the most memorable in financial history, both because of how accurately it described the past and how little it applied to the ensuing decades. World War I of course interrupted the state of affairs that he described, but as we now know was only the first shock to disrupt the system. Caution in forecasting financial globalization therefore seems wise. Following the crisis that began in 2007, with the calls for a Tobin-type tax, the possibility as of early 2012 that one or more members will exit from the Euro, and even the fears of a new Middle East war, few would venture predicting that an immediate further deepening for financial globalization is inevitable. Still, the technology that was so evident in the 'Arab Spring,' namely cheap and easy communications, makes it hard to see how the globalization genie can be put back in the bottle. Then again, that is why true 'shocks' deserve their appellation! Whatever the immediate outcome, this stocktaking is timely.

This project was a labor of love for a great set of professionals who worked tirelessly on this effort: Thorsten Beck, Charles Calomiris, Takeo Hoshi, Peter Montiel,

² A discussion with Bob Aliber, David Love, Peter Montiel, and Ted Truman was useful in this regard.

³ Keynes, J.M., 1920. *The Economic Consequences of the Peace*, Harcourt, Brace and Howe, New York, pp 11–12.

and Garry Schinasi as associate editors were instrumental in early decisions on the shape of the effort and on desired content, as well as of great value in finding section editors and authors. The section editors – Thorsten, Charlie, and Takeo taking on this additional burden, along with Douglas Arner, Philippe Bacchetta, James Barth, Stijn Claessens, Philip Lane, David Mayes, Atif Mian, Larry Neal, Sergio Schmukler, Michael Taylor, and Nicholas Veron – were instrumental in finding the best authors for the targeted chapters and along with those wearing the associate editor hat in reviewing the chapters. Of course, the effort would not exist without the labors of the individual authors, who worked to

bring the reader this unparalleled effort. A huge debt of thanks is owed them, both by me as editor and on behalf of all those using this resource in the future. I certainly learned much and was happy to see that so many busy, first-rate professionals were willing to devote the time and effort to this project. Like globalized finance, immense intellectual efforts such as the present one involve much debt! Unlike some financial debt, however, this one is a debt that will keep on paying.

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February, 2012

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