

Advantages and
disadvantages of
increasing
interdependence and
interconnectedness...



Since the 1970s the 'globalisation of finance' has made the economic fortunes of states increasingly interdependent. Until relatively recently international finance was still considered principally to be an adjunct to trade (McGrew, 2007), a necessary mechanism that enabled the exchange of goods and services at the international level. Its phenomenal growth over the past few decades has shattered this perception. Today the global economy is characterised by the sheer volume and velocity of international financial transactions. Average daily turnover on traditional foreign exchange markets increased from \$15bn in 1973 (Gilpin, 2001) to \$3.2tr in April 2007 (BIS, Sep 2007).

While the successes of financial liberalisation include lifting millions out of poverty in China, East Asia, and elsewhere, and improving the developing world's access to markets, its failures have also been stark. Various crises of the 1990s showed that problems in one country or even a particular industry can fast become global. The recent financial crisis of 2007 has again generated discussion at the normative and theoretical level about the contemporary global financial architecture, its widely perceived benefits, and its increasingly evident costs.

The increasing significance of the global financial system over the past two decades has been mirrored by a surge of interest from the academic field of international political economy. Its effects are now so far-reaching that commentators have drawn connections between international financial integration and such diverse developments as social turbulence in East Asia, monetary union in Europe, and failed development strategies in Latin America (Pauly, 2005). Most of this literature, however, tends to focus on

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specific aspects of financial globalisation, such as its implications for national economic policy or the power of transnational corporations (TNCs).

This essay intends to broaden the debate, to demonstrate the apparent paradox of international financial integration - while it has made states, economies, firms and individuals more intimately interconnected than ever before, it is an inherently divergent process.

It will argue that the international financial system is increasingly producing a global dichotomy. The benefits of financial integration, in the main, accrue to capital-rich states and the owners of capital, those free to move their resources around the world to seek the highest returns. Developing states, and those without control of capital resources, while receiving less of the advantages of integration, are more adversely affected by its disadvantages, such as contagion and capital flight.

The first section will discuss the evolution of the contemporary global financial system, and how it came to be in its current form. I will argue that advanced industrial states, following a neo-liberal paradigm of liberalisation, facilitated the deregulation and increased interdependence of the financial system through political actions. However, it has been technological and market innovation that has accelerated and expanded this interconnectedness to an unprecedented level. These origins are key to understanding why capital-rich entities are better equipped to reap the benefits of financial integration. The next two sections will put forward the principle advantages and disadvantages of this integration. The following section will provide an analysis of these, contending that the capital-poor

gain less of the former, and are more exposed to the latter. The concluding section will summarise this argument and touch on its implications for the future of the global economy – while globalisation promises universal benefits, these cannot be realised under the current system, which precipitates a global dichotomy between the capital-rich and the capital-poor.

Origins of the contemporary global financial system

As Benjamin Cohen (1996) suggests, little consensus exists concerning the causes of financial globalisation, and many scholars have attempted to apply their own structure to the study. The critical contribution to the debate comes from Eric Helleiner (1994), who persuasively argues that the globalisation of finance was advanced by the political decisions of major states. Helleiner also, however, neglects the exponential effect that technological and market innovations have had on the financial system, a factor considered key by others such as Cerny (1993) and Strange (1998).

Political actions by leading states have enabled the globalisation of finance since the 1970s. By far the most significant was the abolition of capital controls, firstly by the USA and the UK, and then other major economies. As Goodman and Pauly (2000) suggest, liberalisation became and continues to be a competitive practice, and other countries had to react to prevent mobile domestic capital and financial business from migrating abroad. By the 1990s an almost fully liberal pattern of financial relations had emerged and today market actors experience freedom in cross-border activity unparalleled since the 1920s (Helleiner, 2007). International capital mobility is the most

significant, and defining, characteristic of the global financial system. It has created many of the advantages and disadvantages associated with integration, and has also been instrumental in creating and sustaining the global dichotomy.

The embracing of a new neo-liberal economic ideology among the major economic powers in the 1980s was key for the international financial system, which was given a large boost by plans to remove the state from the economy and allow the market mechanism to work (Soros, 1998). This theory was less sympathetic to the Bretton Woods ideal that national policy autonomy had to be protected, and was content to let the markets impose an external discipline on governments pursuing ‘not sound’ policies (Helleiner, 2007). Financial liberalisation has been successfully institutionalised as a component of several multilateral agreements (Eichengreen, 2003). As early as 1976 the USA successfully lobbied for a change to the International Monetary Fund’s Articles of Agreement so that the new official goal of the Fund was to preside over a regime that facilitated the free exchange of capital between countries (Watson, 2007).

This regime, however, has been deepened and broadened to an unprecedented extent by technological and market innovations.

The volatility of prices and exchange rates in the 1970s led to phenomenal growth in the derivatives market, particularly after the emergence of an ‘over-the-counter’ (OTC) derivatives market in the 1990s. In 1990 OTC contracts totalled \$3.45bn, which had risen to \$18tr in 1995 and \$24tr by 1996 (Strange, 1998). These new financial instruments involved an initial

outlay only a fraction of the notional value of the contract, giving banks and other TNCs the means at relatively low cost to hedge themselves against losses from unpredicted changes in exchange rates, interest rates, and commodities.

Huge advances in computing and telecommunications over the last thirty years have been central to the huge volume and velocity of international financial flows (Held et al., 1999). Before the 1990s only data could be exchanged instantly between corporate offices and banks. The rise of the Internet meant opinions and rumours could also be traded, contributing to dangerous fluctuations but increasing interdependency. International banks and firms transfer huge amounts of money quickly and safely due to automatic clearing systems. In 1995 the USA's Clearing House Interbank Payment System (CHIPS) became the largest international clearing system processing some 200, 000 transactions a day (Strange, 1998). Today CHIPS, and its state-run competitor Fedwire, clear an average daily value of \$1. 5tr (CHIPS, 2010) and \$2. 5tr (Fedwire, 2009) respectively.

The root causes of the globalisation of finance are crucial to the understanding of its advantages and disadvantages, as it is evident that major states initiated the process because of the benefits it promised to them and to the rest of the world. It is also clear that innovation in both technology and markets has accelerated the process, making the benefits more pronounced for those involved, while also increasing the potential costs.

The advantages of integration

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The advantages of increased interdependence and the expansion of the global financial system are often championed by international institutions, politicians and international business leaders.

At a fundamental level, the benefits cited are backed up by economic theory, that which is at the heart of the neo-liberal paradigm of international finance advocated by many of the world's economies. It holds that markets allocate resources in socially desirable ways. Flows from capital-abundant to capital-scarce countries, on the assumption that the marginal product of capital is higher in the latter than the former, increase welfare on both sides (Eichengreen & Mussa, 1998). International financial transactions allow economies experiencing business-cycle disturbances to smooth the time profile of consumption and investment. Free capital movements thus facilitate a more efficient global allocation of savings and resources to their most productive uses.

An advantage of the expansion of the financial system advocated by the global financial institutions is the convergence of national policies. The neo-liberal programme holds as desirable the homogenisation of national policy across state boundaries. The freedom of capital is said to have enabled the European Union's single currency, tax harmonisation across national borders and the international convergence of macroeconomic policy (Frieden, 1991). This, the argument goes, is good for eradicating instability in the global financial system. The incentive for resources to evade controls and regulations is lessened if national regulations are homogenised. The problem with this argument, however, is that capital mobility breeds a competitive

environment between emerging economies for investment, which will be discussed below.

Some international firms now command more resources than many states (O'Brien, 2005). For these firms, the development of the contemporary global financial system has brought two huge distinct advantages: higher returns on their investments, and the ability to diversify risk internationally.

Higher returns have been produced by two factors – the inherent volatility of the system, and the greater opportunity to exploit it. Firstly, the inherent volatility and uncertainty of the financial system leads to higher returns for investors. Firms are able to trade on the volatile prices of currencies and commodities. With vast capital resources huge sums can be made very quickly with even small fluctuations on international capital markets. The best example of how capitalists gain from this volatility is the benefit that many manage to take from the system's crises. Currency trader George Soros is alleged to have made £1bn from the devaluation of the British Sterling in 1992. Private companies are also said to have benefitted from the Asian financial crisis of 1997. Stiglitz (2002) argues that the intervention of the IMF, a Western-backed institution, ensured that Western firms were paid back their loans, while numerous national firms in Asia were left to collapse. Most of the \$55bn the Mexican government owed following its 1994 crisis was to private creditors (O'Brien & Williams, 2007). The nature of the financial system means that investors can pull money out of a currency virtually instantaneously, and move back in after a collapse making a handsome profit. This leads to self-fulfilling prophecies of currency speculation, discussed below, but the investors are protected from most of <https://assignbuster.com/advantages-and-disadvantages-of-increasing-interdependence-and-interconnectedness/>

the risk involved, whereas the economies concerned can suffer decline for years.

Secondly, with the opening of countries' capital markets, the opportunity for investment has increased substantially. Banks, hedge funds, and international manufacturing firms have all benefitted from having a much larger global market to do business in. With the ease of transferring financial resources to emerging markets and new host states, TNCs have access to a mass global pool of cheap labour. This capital mobility means governments all over the world have to provide more attractive conditions for companies, from low capital gains tax to relaxed financial and labour regulation (Frieden, 1991). Emerging economies, deemed to be high risk, must offer attractive interest rates to attract investment. There is constant competition between economies for foreign direct investment with which to finance development, meaning better and better business environments for investors.

The key advantage for the capital-rich entities is that while gaining from the volatility and uncertainty of the system, they can also protect themselves against it. Modern financial markets operate to allow risks to be packaged and redistributed so that actors can hedge against specific risks like exchange rate fluctuations (Held et al., 1999). High-risk investments yield high returns, but if these investments do not yield, investors are protected by the profits from investments elsewhere. Market innovations such as options, futures and swaps even help protect investors from future fluctuations.

There are also huge advantages associated with the development of the global financial system for less-developed countries (LDCs). The economies of East Asia, China, India and others have shown what can be achieved utilising international investment. Millions have been lifted out of poverty, economies transformed to industrial powers, and their national firms compete at the global level. These developments have been enabled by the crucial advantage of interdependence to smaller economies, access to financial markets.

The opening of financial markets, as Jeffrey Frieden (1991) suggests, has strengthened labour-intensive industries, in which developing economies have a distinct advantage, through increased investment. The ease of transferring capital across national borders has increased the use of outsourcing and facilitated an explosion of FDI in the 1990s to areas like East Asia and Latin America, providing a huge boost to industries in the recipient countries.

Access to financial markets also means that the governments of smaller economies can borrow to fund their development. Borrowing allows such economies to hold their currencies at preferred rates to suppress inflation and keep up debt repayments without inflicting a huge recession at home (Green, 2003). The remarkable development of the East Asian economies would not have been possible without huge inflows of capital, both in FDI and government borrowing to fund economic development strategies.

The disadvantages of integration

While the advantages of greater financial integration mentioned above have helped many less-developed countries expand their industries and grow their economies, their progress has been beset by financial crises, most notably in the 1990s. These crises were notable because they happened in very similar circumstances in completely different parts of the world, and spread across national boundaries and even to different regions.

Contagion of financial crises is the most serious disadvantage of increased interdependence. This effect was most obviously witnessed in the late 1990s, where integration turned a currency crisis in Thailand into the Asian crisis, and turned the Asian crisis into a global recession. Thailand's devaluation made Thai exports very cheap, meaning other economies selling very similar exports to the same markets were forced to devalue in order to protect demand. The crash in Asia precipitated crashes in Russia, Brazil and Argentina. As Jones (2000) explains, the contagious effects of Asia were threefold: psychological upon investors, the collapse of regional markets for Southeast Asian exports, and upon other world markets as demand collapsed.

This demonstrates a key point, that due to the nature of their economies, developing countries bear much more of the cost of crises because of capital flight. As crisis spreads, investors begin to question the wisdom of their investments in, and the reliability of, other emerging market economies. Due to the Asian crisis capital was withdrawn en masse as traders sold the currencies of Russia, Brazil and Argentina for safer currencies in Western Europe, and the dollar. Capital flight also devastated the Mexican economy in 1994-5. From 1990 to 1993 \$91bn flowed into Mexico, a fifth of all capital
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going to developing states (O'Brien & Williams, 2007). Higher interest rates in the USA, combined with a rebellion in Chiapas and the assassination of a presidential candidate, caused investors to doubt that Mexico could keep its peso fixed to the dollar. In December 1994 investors sold the peso in such large quantities that the dollar link was abandoned. Living standards were cut in half (O'Brien & Williams, 2007), the poor suffered, and the middle class faced skyrocketing interest rates and diminished savings due to the devaluation.

Some claim that these disadvantages, and their specific effect on LDCs, are not given proper consideration by advanced states and their neo-liberal programme of reform. As Barry Eichengreen (2003) attests, LDCs have specific financial problems. Their monetary and fiscal institutions lack credibility. Their regulators lack administrative capacity. Their financial markets are shallow, and they cannot borrow abroad in the domestic currency. Stiglitz (2002) protested against the liberalisation agenda being pushed too quickly on smaller states lacking proper financial institutions and banking systems, countries like Mexico and Argentina, which saw 'precipitous and blanket financial liberalisation' (Phillips, 2005). It is now widely accepted that reform was too rapid, and the result of neo-liberal reform in Latin America has been a pattern of poor economic performance and increasing political tension. This lends weight to the argument that capital-rich states have much more to gain from the growth of the global financial system.

What is important for the conclusions of this essay, however, is that it cannot simply be said that the advantages accrue to rich states and the

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disadvantages to the poor, as rich states, and their firms and individuals, suffer disadvantages from integration also.

Advanced states, of course, also suffer from the effects of crisis and contagion. This has been evident from the fallout of the 2007 global crisis, but due to integration it is now increasingly difficult for all economies to insulate themselves against the effects of recession. Crisis in one area of the global economy means falling demand for goods and services in others, and with the scope of international firms, and the vast number of countries in which single firms do business means that collapses have far-reaching consequences.

However, the biggest disadvantage in terms of advanced states is felt by their national industries and firms, those unable to shift production to areas of cheaper labour and production costs. National firms are becoming increasingly unable to compete with firms either in countries with such conditions, or international firms able to conduct business there. This is bad news for the industrial workers of advanced economies, who today can be easily replaced by cheaper counterparts around the globe.

Implications - the emerging global dichotomy

These advantages and disadvantages show that there is a global dichotomy emerging. The principle beneficiaries of the integration brought about by the globalisation of finance are the controllers of capital, those able to move their resources freely around the global economy for the highest return and security. The principle losers are the capital-poor, whether labour or those with assets tied within national boundaries. While China has been one of the <https://assignbuster.com/advantages-and-disadvantages-of-increasing-interdependence-and-interconnectedness/>

biggest beneficiaries economically from financial globalisation, its rising inequality shows that its poorest people, like many others around the world, remain subject to, rather than participants in, the global economy.

The advantages and disadvantages discussed above demonstrate two critical characteristics of the global financial system. First, as internationally mobile capital has become more powerful, so have the holders of it in relation to other groups. The argument that capital now holds a structural power within the system has been advanced by scholars such as Gill and Law (1989), and Thomas and Sinclair (2002). The latter study argues that today the expectations of the resource-rich are anticipated by the resource-poor. In the modern system knowledge workers are fortunate, as they can move to wherever they command the highest salary. Others are manufacturing workers facing fierce competition from counterparts in numerous countries, and still others are subsistence workers trying to survive in a system moving towards broader commercialisation in areas like agriculture. This effect has been compounded by the 'tertiarisation' of global economic activity (Phillips, 2005) brought about by financial globalisation. There is a growing movement towards production and trade of services rather than goods, which produces a divergence between entities that can compete in the service sector and those that cannot.

Second, the leadership role of the most economically powerful states, and the nature of the financial system they have created, has rendered alternative policies imprudent. Susan Strange's (1986) 'casino' has many reluctant players. Capital mobility means sustainable macroeconomic policy options available to states are systematically circumscribed (Andrews, <https://assignbuster.com/advantages-and-disadvantages-of-increasing-interdependence-and-interconnectedness/>)

1994); integration has raised the costs of pursuing policies that diverge from regional or international trends. The fact, as discussed, that there is so much to gain for investors means there is the same amount to lose for countries following policies detrimental to their profits, such as running budget deficits to fund welfare policies.

The global financial system has been directed by an ideology of liberalisation since the 1970s, and the benefits for the capital-rich, the majority of those that lead the modern system, are too great for the direction to change. This could be the reason for the difference between the development of global trade and finance. Financial liberalisation has incredible advantages for capital-rich states, while with open trade LDCs have the advantages of cheap labour and export-led strategies. Advanced states have continued to protect their national industries with degrees of protectionism. While it is an extreme claim that rich states preserve the system because of the dichotomy this essay presents, the evidence is certainly that the major economies still believe whole-heartedly in the theory of globalisation, that its benefits justify this cost.

The recent financial crisis has demonstrated that major states, particularly the USA and the UK, are willing to prop up a system that has shown significant disadvantages in contagion and volatility. This has been a stark example of the asymmetry between the capital-rich and the capital-poor - in the event of crisis traders and investors regroup and take their capital to the safest location in order to resume the pursuit of high returns, while taxpayers and workers face austerity measures and unemployment as investment decreases.

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While the benefits for the developing world have been massive, these benefits are only received by integrating into a system whose disadvantages affect it in a disproportionate way, and which produces a dichotomy, the wrong side of which many of its people will remain. The economic theory behind globalisation still favours trickle-down development rather than bottom-up. The benefits cited by its chief proponents, such as the growth of LDC economies and global economic stability, are no doubt desirable, but they will require a truly global system with truly global markets, neither of which has yet been achieved. In the decades it will take for the global economy to become truly global and precipitate universal benefits, the gap between the capital-rich and capital-poor will continue to grow.

Conclusions

The global financial system has been heading in a single direction since the 1970s, towards liberalisation and the greater interdependence and interconnectedness of economies, firms and individuals around the globe.

This direction was facilitated by the advanced industrial nations through political actions to free international capital, and expand and open global financial markets. Innovations in computing and telecommunications, as well as market innovations, have contributed heavily to the volume and velocity of international capital flows exploiting the volatility and uncertainty of the system.

The emerging strategic interests of the USA, the UK, and later Japan, led them to promote a more open international financial order (Helleiner, 1994).

The major economies' interests still lie in this order, and thus they promote <https://assignbuster.com/advantages-and-disadvantages-of-increasing-interdependence-and-interconnectedness/>

its advantages and push its neo-liberal agenda through international financial institutions and multilateral agreements. This enthusiasm is an indication that the advanced states, and the capital-rich firms and individuals that call them home, have much to gain from financial globalisation, but they also believe in the benefits the neo-liberal programme promises to all.

The problem is that the universal benefits of financial globalisation will only fully materialise under the conditions of a truly global economy, with many more participants than there are currently. It is possible that as markets continue to expand to become truly global, more universal benefits will be seen, but the global dichotomy is likely to grow faster than financial markets and access to them. The challenge for the world economy as it moves forward is how to deal with the social aspect of this expansion.