Financial globalization: recommendations for developing countries

The Next Great Globalization: How Disadvantaged Nations Can Harness Their Financial Systems to Get Rich. By Frederic S. Mishkin. Princeton, NJ, Princeton University Press, 2006, 310 pp., $19.95/paperback, $27.95/cloth.

In this book, Frederic Mishkin makes recommendations to the governments of developed and developing countries and to the international institutions that advise and coordinate their policies. His recommendations are based on his academic background and years of experience working with central banks and international financial institutions. He is a current member of the Board of Governors of the Federal Reserve System.

Mishkin defines financial globalization as the "opening up of a country's financial system to capital flows and financial firms from other countries." According to Mishkin, when first world countries invest in third world countries, they can create an opportunity for a "Great Globalization," which can substantially benefit people in the third world countries. Such investments can bring new methods and technologies that can lower borrowing costs through competition, make more efficient use of capital, and encourage further investment. (This assumes that individual property rights are defined and enforced and that the proper legal, financial, and government regulations are in place.)

The globalization process needs to be closely monitored, however. Opening financial systems to foreign capital flows can lead to crises and backlashes, which can be disastrous. For example, an age of globalization from 1870 to 1914 was followed by a "Great Reversal" when wars and the Depression disrupted capital flows and trade. There is evidence of a similar reversal in Latin America today. Mishkin presents three case studies of modern-day national financial crises. He describes the preexisting conditions and proximate causes of each crisis, and the subsequent developments and recovery.

Mexico. In 1994, foreign banks were not permitted to operate in Mexico and competition was restricted. Four large domestic banks dominated the banking system, and these banks lent sizeable sums to privileged insiders. Debts were often denominated in U.S. dollars. When the peso suddenly fell in value in 1994, debts became overwhelming and the banks were unable to pay them without outside intervention. The ensuing quagmire came to be known as the "Tequila Crisis."

The Mexican government reacted by barring lending to insiders, raising the capital requirements on banks, allowing foreign ownership of banks, and taking over nonperforming loans with the support of guarantees from the US government, the International Monetary Fund (IMF), and other sources. Despite these efforts, recovery was slow. Mexico's eventual recovery was largely a result of its proximity to (and help from) the United States. Loan guarantees helped prop up the currency and allowed the banking system to shore up its foundation. The adoption of NAFTA and the U.S. economic boom of the late 1990s increased demand for Mexico's exports.

The recovery has not been complete according to Mishkin, however. While Mexico has bounced back from the Tequila Crisis, its economy has remained sluggish due to an inefficient legal system that makes it hard to enforce contracts. Some of the most nettlesome snares include a slow adjudication process, ineffective bankruptcy laws, and weak property rights which makes it difficult for banks to lend to private parties. Instead of relying on the financial system to get funds, firms now get financing from their suppliers. Although some headway has been made in establishing a new bankruptcy code and strengthening the rights of creditors to collect collateral, Mishkin claims the reforms have only partially resolved the situation. Because the government was slow to act during the crisis, banks had to close or be sold to other financial institutions. And, because it was Mexican taxpayers who ultimately bore the cost of the bailout, their confidence in the financial system has been hard to restore.

South Korea. In the mid 1990s, giant conglomerates had special borrowing advantages and implicit government guarantees that they would not fail; consequently, they took on great risks and circumvented normal regulations. As a result, the financial system became fragile. When a currency crisis began elsewhere in Asia in 1997, investors lost confidence that the Korean currency would hold its value. Important financial institutions were too weak and indebted to survive.

Mishkin considers the South Korean government's rapid and effective response to be a useful model for crisis management. By passing 13 reform bills (with an emphasis on transparency, accountability, and sound financial practices), it quickly restored confidence in the financial system

and reduced the power of the former opposition leader. The government also campaigned for ordinary citizens to overcome the national crisis rather than blame foreigners.

Argentina. To prevent inflation, the government fixed the exchange rate of its peso to the U.S. dollar in 1991. Inflation fell and economic growth was rapid. The collapse of the value of the Mexican currency in 1994, however, led to a number of negative consequences for Argentina. It caused a rush to exchange Argentine pesos for U.S. dollars and led to a rise in Argentinean interest rates. Concerns about the banking system led to a decline in bank deposits. The percent of credit in U.S. dollars increased. Because the government had not exercised tight fiscal management during the earlier prosperity, the debt-to-GDP ratio rose to dangerous levels. The combination of dollarization (occurring when the inhabitants of a country use foreign currency in parallel to or instead of the domestic currency), imprudent fiscal policy, and product market inflexibility also contributed to Argentina's woes.

A crisis took place during 2001 and 2002 when the peso became overvalued. A sudden stop of financial capital inflows led to an increase in interest rates. Investors sold pesos and Argentina's international reserves fell. Doubts about the stability of banks led to a decline in bank deposits. A recession started and unemployment rose. This in turn led to a collapse of the government's currency board, the body that is charged with holding the peso's value steady. Inflation surged, interest rates rose, and the unemployment rate climbed above 20 percent. Fortunately, foreign demand for Argentine agricultural products rose, which supported a natural bounce back to recovery in 2003. Since the economy was open to trade, the financial crisis was less severe.

These case studies help illustrate four key themes of the book concerning financial crises. First, financial crises are unique to each country and can result from inadequate prudential regulation and supervision, irresponsible fiscal policy, or any combination thereof. Second, a pegged exchange-rate regime and large amounts of debt denominated in foreign currency are a combination that leaves emerging market countries vulnerable to financial crises. Third, strategies that work well in advanced countries cannot be applied to emerging market countries on a "one size fits all" basis to prevent crisis or hasten recovery. Finally, governments exacerbate financial crises by hesitating to address problems before they become too serious.

In order to address these issues and get financial globalization right, Mishkin recommends full disclosure to creditors and depositors, preventing government ownership of banks, limiting the degree to which liabilities are denominated in foreign currencies (which Mishkin calls currency mismatch), and ensuring that banks have plenty of capital. "Too big to fail" policies should be eliminated; even large banks and corporations must be allowed to fail. Mishkin concedes that many of his recommendations are not simple and suggests several guidelines to help implement them: sequence financial liberalization, because in the short run the lending boom may become a bubble and lead to a collapse in asset values; reform fiscal policy to prevent excess budget deficits; and promote price stability through the monetary policy framework.

According to Mishkin, the IMF should operate only as an international lender of last resort. It can restore confidence in the financial system by quickly providing short term liquidity at the government's request but it should avoid labor and environmental issues. It should limit moral hazard problems by encouraging adequate prudent supervision. Support should be available only to governments that are serious about implementing the necessary reforms. The IMF also needs to closely monitor the economic performance and financial policies of its member countries.

Mishkin recommends that international financial institutions and citizens in advanced countries provide assistance and open their market to the goods of poorer countries. At the same time, disadvantaged countries must take responsibility for their fate by developing the institutions needed to foster economic growth. When external institutions simply throw money at the problem it typically engenders nonperforming loans and investments that can inadvertently prop up corrupt regimes.

In summation, in this dense, informative, and valuable (albeit somewhat repetitive) book, Mishkin attempts to convince readers that people in developing countries can benefit from financial globalization and avoid crises. Successful financial globalization requires dedication, hard work, commitment, and time. To achieve the desired results, Mishkin recommends that leaders in both developed and developing countries should protect themselves with the measures that he outlines.

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