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Integration of Financial Markets - Global Crisis and Its Contagious Effect

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ABSTRACT

***Key Words:* Globalization of investment, integration of financial markets, financial crisis, financial system, Bail-outs**

Global production, marketing, human resource and finance functions are no longer restricted to national boundaries. Consequently, financial markets are closely integrated across the globe that has benefitted both corporate and investors of transnational boundaries. However, the integration of global financial market is like a double edged sword that has offered enough avenues for both fund seeking corporates and investors. On the other hand, it has carried evil effects in its underbelly the financial crisis like Subprime crisis of developed West. Global financial crisis in the recent past (2008-2011) that has occurred in U.S carried the ripple effect on India too. Furthermore, financial crises occurred in the last two decades – to name a few - Argentina and Mexican currency crises, financial crisis of PIGS (Portugal, Italy, Greece and Spain), South East Asian currency crisis were more pronounced on the contagious effect on the global trade and investment. The intent of this paper is to analyse the causes behind such crises, their effects on trade and investments and the lessons learnt for the future policy measures to be adopted by nations round the globe and International Financial Institutions.

1. INTRODUCTION

Nowadays, production, consumption and investment are globalised (Eun & Resnick, 2015). Sensing this trend, Infosys founder Naryana Murthy opined, “Globalization as producing where it is most cost-effective, selling where it is more profitable and sourcing capital where it is cheapest, without worrying about national boundaries” (Jacque, L.L, 2014).Thanks to the initiatives taken by the developed countries in 1980's and 1990's for integrating global capital markets and financial markets; this has offered ample opportunities to the fund seeking corporates and investors. However, one should not forget the fact that integration of financial markets transmits the evil effects of global financial / currency crisis from one nation to another like a contagious disease. This became an open secret from a series of crises occurred during the last two decades - the Mexican Peso Crisis (1994), South-East Asian Crisis (1997), Argentina Peso Crisis (2002), Sub-Prime Crisis (2007-08) and Greek Crisis (2009).

The chronic effects of these financial crises were not restricted to the country of its origin, but it spread like contagious disease from one nation to another. In fact, the global financial crises were the crisis of developed world rather than the malaises occurred in developing or emerging world (Madhura & Fox 2017). Repercussions of aforesaid financial crises have manifested in term of debt servicing problem, currency devaluation, sharp decline in asset portfolio, capital flight, bankruptcy, mounting unemployment rate in afflicted countries. Rising inflation and interest rates, credit crunch, severe austerity measures which further aggravated the situation. Every nation has a lesson to learn from these financial crises and can initiate suitable policy measures to prevent their occurrence.

The main intent of this paper is to analyse the various cases of financial contagions that occurred in the recent past with global impact. This paper throws light on the antecedents and its impact on certain economic indicators. Apart from it would like suggest strong policy measures for the developing countries to safeguard themselves against global financial contagions. This paper is organized as follows: immediately after a brief introduction, in section two there will be a brief literature survey on important studies conducted elsewhere. Section three clarifies the objectives of the present study. Section four speaks about the methodology, whereas the fifth section gives the retrospective analysis of the financial crises, which includes Mexican Peso Crisis. South East Asian currency, Argentina Peso crisis, the US sub-prime crisis and Greek Debt crisis. When section six to addresses the policy measures to be taken up based on the lessons learnt from these crises and to overcome these types of crises in future, section seven focuses on suggestions. Finally section eight gives the conclusions drawn.

2. LITERATURE REVIEW

It is a well-known fact that integration of financial markets into one international financial market enabled business entities to raise funds without restricting themselves to their domestic market. At the same time, it opened up new avenues to the investors as well. Ironically, integration of financial market played an important role especially during currency/ financial crises to carry their adverse effects. An attempt has been made here to analyse the extant literature on global financial crisis on various issues.

Nicolas A.B (2017) examined the degree of integration of emerging markets with the world markets and amongst them. He made an attempt to explore the impact of Global Financial Crisis 2008 and structural breaks in the degree of integration. Apart from it, global financial crisis is a major driver for the recent increase in world market integration. The degree of global integration of emerging markets exceeds their degree of integration among themselves. The breaks in the world market integration is largely coincide with the global financial crisis, whereas that of emerging market integration is dispersed.

Gurdgiev et al., (2016) analysed the volatility spill

overs from the Advanced Economies' equity markets (Japan, the United States and Europe) to the four key emerging markets (the BRIC). They found that the developed economies weighted return volatility did have a significant impact on volatility across all four of BRIC economies returns. Surprisingly, there was no evidence of volatility spill over from Advanced Economies to BRIC economies with the exception of a spill over from Europe to Brazil.

Ali Salman Saleh et al., (2017) made an attempt to find the relationship between family ownership and firms' performance during financial crisis period, reflecting on the higher risk exposure associated with capital markets. The results of the study revealed that family firms with the ownership concentration performed better than non-family firms with the dispersed ownership structures. Ownership concentration has positive and significant impact on family and non–family firms during crisis period. Moreover, financial leverage had a positive and significant effect on the performances of Australian Family- owned firms during both pre and post crisis period

Ashrafee, T.H. and Lawrence, K (2019) through extant literature review, identified four main causes of global financial crisis – excessive household leverage, securitization, corporate governance and credit ratings. The recovery measures that most governments adopted were Quantitative Easing (QE), bail-outs and more stringent regulation of banks.

Ekta Sikarwar (2018) conducted study in India having an objective to examine the presence of exchange rate exposure and its relationship with currency derivatives usage in the dynamic environment of global financial crisis of 2008 comprising of 624 Indian forms over the period of April 2001 – March 2016 . She found that the firms are more expose to exchange change rates since the onset of financial crisis. However, there is lack of evidence that the usageof currency derivatives is more effective in reducing exposure during crisis/post – crisis period as opposed to pre - crisis period.

Jamshed and Inayat (2013) study underscores the inadequacy of quantitative risk models during financial turbulence and the need for prudential exercise of judgement in risk management.

Irina Bunda et al., (2011) analysed the impact of the global financial crisis on capital flows, financial markets and economic activities in emerging and newly industrialised Asia and tried to explain why Asian markets were hit hard despite relatively strong fundamentals and what subsequent recovery was relatively quick. The openness of country to trade and finance, and degree of integration into financial markets are the key determinants of swings in economic activity and capital flows during both the reversal and recovery phases. Study also highlighted the role of macroeconomic and financial policies in the recovery.

Kimie Harada et al., (2015) evaluated Japans

financial regulatory responses after the Global financial crisis and recession in five areas (Bessel III Stress tests), over the counter derivatives regulation, recovery and resolution planning, and banking policies for SME lending. They concluded that the effectiveness of the new regulations for financial stability critically depends on the willingness of the regulators to use new tools.

Minh Quang Dao.,(2017) found that good macroeconomic fundamentals together with more open financial policy, financial liberalization, financial depth, domestic performance, and favoured global conditions do lineally influence national GDP growth. Over 85 percent of cross-country variations in GDP growth during the recovery phase of the global financial crisis can be explained by its linear dependency on pre-crisis national GDP growth, financial liberalization, financial depth, domestic performance, as well as interaction terms between various explanatory variables. Cross-country differences in national GDP growth also linearly depend on macro prudence and on favourable global conditions.

3. OBJECTIVES OF THE STUDY

The main objectives of this study are as follows:

1. To give an overview of important currency /financial crises occurred during the last two decades across the globe.
2. To identify the antecedents of select financial crises chosen for the study.
3. To analyse the impact of currency/financial crises on investment and flow of capital across nations, and the techniques adopted to encounter the challenges.
4. To suggest appropriate policy measures based on lessons learnt from these crises.

4. METHODOLOGY

Various published cases of currency/financial crises across the globe encountered and ameliorated were selected and put into a rigorous analysis to extract the causes behind, strategies and policy measures adopted to iron out the contagion.

5. CURRENCY / FINANCIAL CRISES – AN ANALYSIS

International Monetary System is an institutional framework within which international payments are made, capital movements accommodated and exchange rates among the currencies are determined(Eun & Resnick, 2015).It was evolved over the period of time and continued to exist in future too. The stages in the evolution of International Monetary System comprises of bi-metallism, classical gold standard, inter-war period, Britain Woods system and present flexible exchange rate regime. The exchange rates were more or less stable during bimetallism and classical gold standard. However, due to various political and economic upheavals, currency exchange rates were highly volatile during inter-war period and Britain Woods system. Eventually, the closure of Britain Wood system gave birth to Flexible Exchange Rate system since 1973.

the action was very impressive as it curtailed Argentina's chronic inflation and contributed towards influx of foreign investment to the country. However, these positive economic effects were not free from pitfalls. As the US dollar saw upward trend on the world market, the Argentina Peso also strengthened. But rising Peso adversely affected the exports from Argentina causing economic downturn. This led to abandonment of Peso-dollar parity in Jan 2002. Consequently unemployment rate rose above 20 percent and monthly inflation rate reached about 20 percent. The main causes of Argentina crises are lack of financial discipline, labour market inflexibility and contagion from the financial crises of Brazil and Russia (Eun & Resnick, 2015).

5.4 Sub-Prime Crisis (2007-2008)

Dot.com bubble burst (2000 – 2001) in the United States, led to the diversion of capital flows route towards real estate sector in the U.S, despite the corporate lending was still slow. The US banking sector focussed its attention towards real estate sector as it perceived the sector was most promising and profitable. The hype in real estate sector led to sharp increase in real estate prices and growing number of borrowers with lower credit quality (sub-prime debt).

The roots of subprime crisis emerged from early 2000 when banks and financial institutions started lending to households and awarded large mortgages to property developers without focussing on their ability to replay. Unsurprisingly, sub-prime borrowers default rates showed rising trend, which forced major financial institutions to borrow large amount of capital to restore their balance sheets. Rumours started mounting about financial health, panic spread, confidence in the banking sector shattered and institutions with surplus funds were reluctant to lend amidst uncertainty. The ensuing 'Credit Crunch' badly affected the banks and other financial institutions which were highly dependent on interbank funding. Eventually, full blown crisis had culminated in the collapse of two giant investment banks – Lehman Brothers and Bear Sterns (Stiken & Bowen, 2013). In the era of globalization of financial markets and integration of financial and capital markets, the pinch of Sub-Prime Crisis was quickly transmitted to other European and emerging economies though crisis originated in US.

The effect of subprime crisis was evident in credit crunch, fall in asset value, bankruptcy of lenders, capital flight, continued recession, reduction in the US inflow of capital. Subprime crisis has majorly impacted India's stock market mainly due to the withdrawal of FII's, export, IT and BPO sector. These developments forced the US government to go for bailout plans; similar bailout programmes in UK, France and other European countries were also initiated.

5.5 Greek Debt Crisis

Though Greece was the member of European Union, it could not succeed in obtaining entry into common currency Euro Club in 1999 when Euro was introduced, as it failed to satisfy the stringent

5.1 Mexican Peso Crisis

On 20 December, 1994 Mexican government announced its plan of devaluation of Peso by 14 percent against the US dollar. The Mexican government's plan led to escalated currency speculation among the traders and they tried to get rid-off Mexican Peso. In their effort to exit, Mexican Peso fell by as much as 40 percent. Further it led to cross border flight of capital.

5.2 The Asian Currency Crisis

The major cause for the Asian currency crisis of 1997 was attributed to excessive dollar bank debt. The currencies of Thailand, Korea, and Indonesia were pegged to (fixed) the US dollar. Each of these countries were undermined by a fixed exchange rate, experienced huge current account deficit and foreign currency denominated obligations. On July 2, 1997, the Thai currency Baht which was pegged to the US dollar suddenly devalued. Initially Thai financial crisis was in the nature of local financial crisis, quite quickly escalated and disseminated to other Asian countries – Indonesia, Korea, Malaysia and the Philippines. Then it spread to Russia and Latin America especially Brazil (Eun & Resnick, 2015). When Asian crisis reached its climax, Korean Won fell 50 percent against US dollar, while Indonesian rupiah depreciated an incredible 80 percent compared with pre-crisis level (Eun & Resnick, 2015). Korean economy's gained from persistent depreciation of its currency debt was invested in export oriented industries. Unfortunately investors in Thailand and Indonesia diverted their foreign currency debt to speculative local property ventures. Increased currency speculation among the traders, forced each of the countries to come out of fixed peg as it exhausted its forex reserves. Each of the currencies lost more than 50 percent of its value (Butter Kirt, 2016).

The consequence of Asian crises are: firms with foreign currency bonds was compelled to bankruptcy, local real estate and stock market values crashed resulted in capital flight, wide spread recession due to the austerity measures, downgrade in credit rating, raise of domestic interest rate and cut in government expenditure. The industrial production dropped by more than 20 percent in both Thailand and Indonesia which was comparable to the US and Germany during great depression of 1930s. Though IMF came out with bailout plans, it was something like prescribing wrong medicine to afflicted Asian countries. Bailout plans of IMF came under severe criticisms. Former U.S Senator Lauch Faircloth was quoted saying, “Through IMF we have privatised profits and socialised losses”

Moreover, IMF bailouts encouraged dependency among developing nations and risk taking on the part of international investors. The impact of Asian crises was for more serious than Mexican crisis in terms of its severity and contagion effect on economic and social cost.

5.3 The Argentinean Peso Crisis (2002)

Through convertibility law in 1991, Argentina government linked its currency Peso to the US dollar at parity. The initial economic outcome of

norms of European Union pertaining to budget deficit and government debt vis-à-vis GDP. The European Union convergence guidelines prescribed that the budget deficit must be below 3 percent of GDP and debts must be below 60 percent of GDP. After 10 years from the inception of Euro, in 2001, the politically motivated leaders of European Union succeeded in securing entry of Greece to Euro club. Entry of Greece to Euro club provided easy access to ample funds at historical low rate of interest. This led to enormous credit growth in Greece. But the fruits of this move did not last for a longer duration.

In December 2009, the New Greek government revealed that the budget deficit would be 12.5 percent as against 3.7 percent as announced by the outgoing government. This figure was regarded as very high as per the convergence guidelines. As the outgoing government mis-reported the true picture of country's economic health for several years, and when picture became public, the prices of Greek Bonds began look southwards, panic selling by international investors resulted in capital flight, threatening the sovereign defaults. Even after several years of Greek Debt crisis, the Greek Government debt stood around 180 percent of GDP, jobless youth above 50 percent and GDP fell by 25 percent. The shock waves created an alarm situation in other European countries like Portugal, Italy, Ireland, Greece and Spain (PIIGS), because they also had similar features.

To rescue Greece, sever austerity measures such as sharp rise in tax rates, reduced pension benefits were imposed by European Union, IMF and European Central Bank. In addition to these to prevent run on banks, access to bank accounts were restricted. All these developments of Greek tragedy led to demand GREXIT from common currency club by the country like Germany in the opinion poll. The international credit rating agencies downgraded Greece's Debt ranking. For instance on 27th April 2010, S&P cut Greek government Bonds to BB+, just below investment grade, the market confidence vanished and persuaded large scale selling by private investors.

6. LESSONS LEARNT

- Mexican Peso crisis revealed the fact that massive inflow of capital leads to overvaluation of currency and it also highlighted the need for International safety net to safeguard financial system.
- South Asian crisis have taught a lesson that before liberalizing their financial markets it is essential to strengthen their domestic financial system.
- Argentina Peso crisis indicated that over dependence on Currency Board Arrangements, lack of fiscal discipline and labour market inflexibility are dangerous during financial crisis.
- Emerging countries are living beyond their means which is evident from their fiscal deficit and excessive borrowing through foreign currency denominated bonds.
- The current capitalist-based economic view is that the regulations obstruct wealth creation in the markets. Underestimation of risk, poor

diversification, and poor regulation of financial markets and introduction of innovative financial instruments ignoring their implication give shock waves that were difficult to fathom.

- From the Greek crisis it was obvious that political motivations and non-fulfilment of convergence guidelines regarding fiscal debt and foreign currency debt may lead to disasters.

7. SUGGESTIONS

Having analysed the sordid experiences of various countries in confronting financial crisis either their own making or inflicted for being the member of world community, as a good counsel it can be suggested to contain the financial contagion in the years to come:

(I) Complete fixed exchange rate regime or complete flexible exchange rate regime would save the countries from these types of currency crisis. However, a sort of control on capital account is desirable, especially in case of developing or fast emerging economies. For instance, China and India were least affected from Asian Crisis due to capital account control.

(ii) All the countries must strictly enforce the Basel Norms Accord. However, it is to be borne in mind that too strict enforcement of Basel II measures led to credit crunch in the United States during Sub-prime crises.

(iii) Investment banking and commercial banking are two separate compartments and are not allowed to mingle together.

(iv) There should be proper risk estimation before lending and there should be appropriate hedging tools.

(v) There should be enforcement of strict financial discipline among the lenders as the global financial crises have been the crises of the developed world rather than developing world. An international safety net is essential.

(vi) The three fundamental policy objectives includes fixed exchange rate, independent domestic monetary policy and free flow capital are conflicting with each other. It is quite difficult to attain all these three objectives at the most two objectives can be attained hence a harmony among these fundamental policy objectives is a must.

8. CONCLUSIONS

Global currency / financial crises transmitted from one nation to another through various mechanisms trade links, integration of capital market and public debt policy. The causes of these crises are attributed to the proximate and structural factors. The most significant reasons are fixed peg arrangements, poor financial discipline, poor risk assessment, influx of foreign portfolio investments, excess foreign currency denominated borrowing and fundamental policy conflicts. The impact of these global financial crises were reflected sharp currency devaluation, collapse of real estate / stock market, drastic fall in the value asset portfolio's, high capital, rising inflation and sharp interest rate, ongoing recession adversely affecting industrial production and unemployment opportunity.

Yet, there is no 'sure fire solution or one size fits all solution' to contain various types of financial contagions. During the preceding years, human ingenuity created a 'global financial order' and do hope that too much financial creativity will not spoil the health of well managed economies in the years to come.

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