

Financial Crises and Globalisation

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Abstract: *International economic integration puts a country's fortunes partly into the hands of others. When integration takes the form of financial interdependence, the potential domestic impact of external events is magnified manifold. The global economic crisis of 2006–2008 and the European sovereign debt crisis that followed have unleashed market forces that even policymakers in the mature economies were ill prepared to counteract. The existing informational and institutional structure for global policymaking remains woefully inadequate to the challenge of financial globalization.*

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I. Introduction

Even before the global financial crisis, net financial flows between countries, in the form of current account deficits and surpluses, were a focus of policy concern and disagreement. While the general scale and persistence of current account imbalances certainly has increased over the past two decades, even more striking – and potentially more threatening to financial and economic stability is the rapid expansion of gross international asset and liability positions. Net international asset positions certainly remain relevant for several purposes, as I will maintain below, but it is the gross positions that better reflect the impact on national balance sheets of various economic shocks, including counterparty failure.



After all, a Portuguese external debtor cannot automatically mobilize the assets of a separate Portuguese external creditor to pay off his or her debts. This fact makes it even more unsettling that Portugal's net external liability amounts to well over a year's GDP. The sheer increase in the volume of gross international positions could in theory represent an improving global allocation of income risks, but recent experience shows that these positions also can lead to the transmission of economic shocks between countries, with strong amplification of their effects.

In light of the rapid growth of gross global financial flows and the risks associated with them, one might wonder about the continuing relevance of the net financial flow measured by the current account balance. I argue that global current account imbalances remain an essential target for policy scrutiny, for financial as well

as macroeconomic reasons. Nonetheless it is critically important for policymakers to monitor as well the rapidly evolving structure of global assets and liabilities.

II. International trade of goods for assets and of assets for assets

Countries exchange assets with different risk profiles to smooth consumption fluctuations across future random states of nature. This intra temporal trade, an exchange of consumption across different states of nature that occur on the same date, may be contrasted with inter temporal trade, in which consumption on one date is traded for an asset entitling the buyer to consumption on a future date. Cross-border purchases of assets with other assets are intra temporal trades, purchases of goods or services with assets are intertemporal trades.

A country's inter temporal budget constraint limits the present value of its expenditure to the present value of its output plus the market value of its net financial claims on the outside world. Thus, a country's ultimate consumption possibilities depend not only on the NIIP, but on the prices a country faces in world markets and its output and investment levels.



Ideally, if a country has maximally hedged its idiosyncratic risk in world asset markets, its NIIP will respond to shocks (including shocks to current and future world prices) in ways that cushion domestic consumption possibilities. Furthermore, if markets are complete in the sense of Arrow and Debreu, asset trades between individuals will indeed represent Pareto improvements in resource allocation, so that it makes sense to speak of countries as if they consisted of representative individuals. But this type of world a world without crises is not the world we inhabit. In the real world, financial trades that one agent makes, viewing them as personally advantageous, can work to the detriment of others. The implication is that the sheer volume of financial trade can be positively correlated with financial instability risks.

III. The growth of pure asset-for-asset international trade

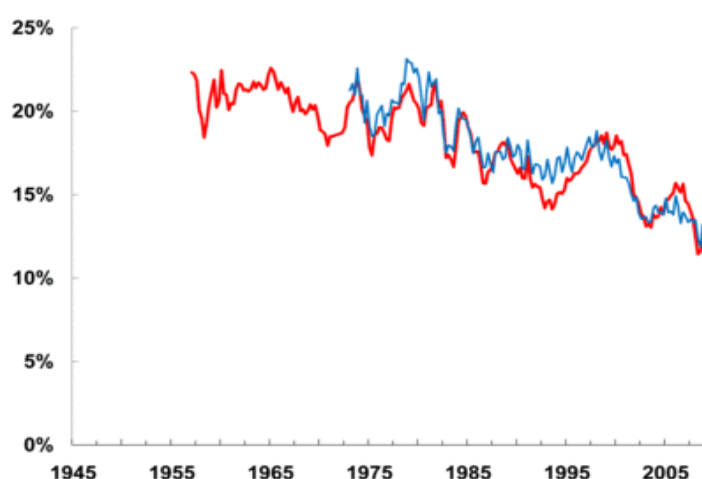
In explosive growth appears to have occurred for several economies, especially smaller economies that are also financial hubs. While the gross asset and liability numbers for the United States are less exorbitant than those for smaller financially open economies, a look at the changing role of gross asset flows in the U.S. balance of payments is suggestive of the growing importance of international asset trade relative to trade in goods and services.



In the mid-1980, gross financial flows were considerably smaller than trade flows, but the former have grown over time and on average now are of comparable magnitude to trade flows. Of course, international flows of investment income have grown over time as well as gross foreign asset and liability positions have grown. These non-flow changes far overshadow the effect on the U.S. current account deficit, which fell to 4.7 per cent of GDP in 2008 and to 2.7 per cent in 2009. For smaller financially open economies, especially those like the United Kingdom with independent currencies, the valuation effects can be far larger.

IV. Current account matter anymore on globalisation

One could make two arguments that the current account has become irrelevant in today's world. Paradoxically, however, the two arguments rest on directly opposite visions of the way the world works. I will argue against both of them, although one is much closer to the mark than the other. The first argument takes the high volume of asset-swapping as proof that countries have extensively diversified their idiosyncratic risks in sophisticated, well-functioning markets for contingent securities. In this world of virtually complete Arrow–Debreu asset markets, countries pool their risks to the maximum feasible extent. In the extreme case of a pure endowment economy, idiosyncratic income movements are offset completely by net insurance payments from abroad, so the current account balance is always nil. With investment, the current account's role is to allow investors to maintain globally diversified portfolios of equity claims through purchases of newly issued shares in the profits of capital. But the sheer volume of asset swapping, particularly among the advanced industrial economies, is far greater than what simple risk-sharing models based on equity trade would imply. Moreover, the complete-markets account of international asset trade is not supported either by statistical or anecdotal evidence, chief among the latter category being the long history of global financial crises. It is certainly correct that gross asset foreign and liability positions offer the best picture of potential stability risks, and that hazardous gross positions can build up even in the absence of any net international capital flows. Acharya and Schnabl offer a superb detailed example of the negative forces generating large gross positions, based on the proliferation of bank-sponsored asset-backed commercial paper conduits that helped kick off the global crisis in 2007. Banks set up these conduits to hold AAA-rated asset-backed securities backed by mortgages, corporate loans, credit card receivables, and other long-term debts. They financed these holdings by selling short-term asset-backed commercial paper, predominantly to U.S. money-market funds. As Acharya and Schnabl document, in many countries these conduits were effectively guaranteed by the sponsoring banks, yet the conditional nature of the guarantee allowed the banks to reduce or avoid altogether the regulatory capital held against the conduit's assets. In contrast to theories viewing current account imbalances in the 2000s as being determined by emerging markets' thirst for safe assets, banks outside the U.S. were issuing plenty of "safe" assets while investing the proceeds in less liquid and less safe assets located primarily in the U.S. but also in the United Kingdom, Spain, and even some current account surplus countries such as the Netherlands. Banks in current account surplus and deficit countries alike sponsored asset-backed commercial paper conduits. When a Landesbank-sponsored conduit finances a purchase of U.S. assets by issuing asset-backed commercial paper to a U.S. money-market fund, U.S. gross foreign assets and liabilities, and German gross foreign assets and liabilities, both rise by the amount of the transaction. No net financial flow takes place. The trade is privately profitable, but the profits come from socially costly sources: higher systemic financial instability due to the avoidance of capital requirements, and the resulting enhanced probability of government bailout. In short, the trade is driven, not by initial economic inefficiency, but by regulatory arbitrage and moral hazard. These social risks were realized in 2007 when the AAA-rated assets held by the conduits became toxic and the conduits found themselves suddenly unable to roll over their short-term credits.



Such financing patterns undeniably determined the impact and propagation of the global financial crisis. Does it follow, however, that because banks in surplus and deficit countries alike got into trouble, the prior pattern of global imbalances was unrelated to the crisis? That strikes me as similar to arguing that because German banks got into trouble and Germany had no housing boom, house-price bubbles were likewise unrelated in the crisis.

Intuition based on a two-country or two-region paradigm can be very misleading in assessing the risks posed by the multilateral pattern of gross financial flows in a many-country world; and position data based on residence rather than nationality may mask the ultimate natures and repositories of the risks. As Hume and Santance observe, the net inflow of capital from emerging to advanced economies is quantitatively far less than the amount of domestic credit those economies generated in the run up to the global crisis.

Nonetheless, it would maintain that large and persistent current account imbalances can be an indicator of trouble ahead, as they were in the 2001, and therefore deserve close monitoring by policymakers. Low interest rates due to global saving and investment patterns, along with accommodative monetary policy responses and other government policies, promoted credit and housing booms that themselves led to a further widening of the global imbalances. Financial competition, innovation, and arbitrage, proliferating within a lax regulatory environment, built a financially fragile superstructure of gross liabilities and claims on the back of those unsustainable booms. The big U.S. external deficit was a symptom of underlying destabilizing forces, and indeed enabled those forces to play out over an extended period.

Studies such as this do not directly address the link between credit booms and the current account because the net inflow of private capital and the current account deficit need not coincide: even a country with a current account surplus may experience a net inflow of private capital if it is accumulating a sufficient volume of foreign exchange reserves. Examine the question more directly, utilizing fourteen decades of data for a sample of advanced countries, and conclude that “The current account deteriorates in the run-up to normal crises, but the evidence is inconclusive in global crises, possibly because both surplus and deficit countries get embroiled in the crisis”. Reinhart and Reinhart find evidence that current account deficits help predict crises in developing countries. The general question merits further research.

In the meantime, I believe that large and persistent current account deficits while sometimes benign and sustainable, warrant careful scrutiny with no presumption of innocence. External deficits may not be the true source of a problem – nor is the problem necessarily addressed most effectively by seeking directly to reduce the external deficit – but it is nonetheless prudent to be suspicious.

Looking at the current predicament of the euro zone, it is easy to argue, that its current account imbalances after 1999 were symptomatic of unsustainable trends Greece’s government deficit, housing and construction booms in Spain and Ireland, and excessive private borrowing in Portugal, with finance provided in large measure by European banks that now find themselves in trouble. Sometimes we must simply ask whether a country is in a position to fully service its net external debts, even when they are reckoned on a consolidated national basis. This is a necessary condition, if not a sufficient one, for crisis-free foreign borrowing. If the answer is negative, a further question arises: Who is likely to be dragged into the eventual crisis as a result of their gross asset and liability positions vis-à-vis the country in question

In assessing the sustainability of current account deficits, we cannot take too much comfort from the seeming decoupling between cumulated current account imbalances and the NIIP, which was illustrated for the U.S. For one thing, the current account is the more predictable component of the change. Only for the U.S. is there some reasonably strong evidence that net exports help predict subsequent valuation changes.

Indeed, it is hard to think of a plausible model in which the direction of the current account does not predict the direction of the, at least over a medium-term horizon. There should be no expectation of borrowing indefinitely at a negative rate of interest. This pattern, which may have ended with the collapse of 2008, is reminiscent of self-reinforcing dynamics during credit boom episodes. In credit booms, asset values rise, improving balance sheets and facilitating the further expansion of credit. As a result, subsequent collapses are all the more traumatic. A capital inflow episode likewise may strengthen financial sector assets and even the NIIP in the receiving country in a way that pushes domestic borrowing beyond the point of true sustainability. This often sets the stage for a disorderly collapse later on. In diagnosing such situations, it is essential to keep the underlying credit flows in clear view.

A purely macroeconomic perspective also argues for the continuing importance of the current account as a component of aggregate demand. The emergence of a current account surplus in one region may depress aggregate demand globally, affecting global financial markets and eliciting policy responses in trade partners. Large global imbalances may also encourage protectionism.

V. Conclusion

The evolving world of financial globalization can be a dangerous place. Unfortunately, policymakers still lack an adequate institutional infrastructure for assembling consolidated global information on financial activity, for regulating against macro risks, for providing liquidity support, and for resolving insolvent global financial institutions and governments. For several reasons, the current account still matters. Recent experience shows, however, that gross international asset and liability positions furnish the key conduit through which financial meltdown is transmitted and amplified. A given current account imbalance can be financed in many different ways, by a multiplicity of different partners in asset trade, including partners whose own current accounts are in balance. But national divergences between saving and investment not only remain key macro variables, they may well reflect financial developments with direct systemic implications. If policymakers are not to remain in over their heads, institutions at the global level, and not just the euro zone level will require wide-ranging extension, based on greater cooperation, including fiscal cooperation, on the part of the international community. It bears repeating that a key aim of such institution building must be to improve the informational basis on which cooperative international policy decisions are made.

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