Chapter 2
Theoretical Links to Financial Integration
And
Financial Integration: Poverty Nexus

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2.1 Introduction
The degree of integration of financial markets around the world increased significantly during the last couple of decades. The increased globalization of investment, high return seeking behaviour and the opportunity to diversify risk internationally are the key factors responsible for this process. At the same time, many countries have encouraged inflows of capital by dismantling restrictions, deregulating domestic financial markets and improving their economic environment and prospects through the introduction of market-oriented reforms. For western countries, investment in emerging markets was a hedge, and for developing countries, financial integration was an opportunity to finance the process of economic development in their countries. Thus a financial relationship was easy to build between developed and developing countries. It appeared that all that was needed was the liberalization of finance and a monetary policy that ensured interest rates high enough to make capital inflows attractive, even after adjusting for risk. Thus the process of financial integration got initialized and developed in the world economy.

The increase in the degree of integration of world capital markets has been accompanied by a significant increase in private capital flows internationally.
Cross-country trends in capital flows show that private capital flows have now become dominant and official capital flows have reduced to minimal. At the same time, a rise in portfolio capital has increased the proportion of short-term investments in international capital flows. This makes individual countries more vulnerable to enhanced volatility and risks of sudden withdrawal of capital. The world has also been experiencing financial crises increasingly. These international trends have raised the questions about the desirability of the financial integration. Whether the costs of increased vulnerability to financial fragility outweigh the gains from financial integration, is of a greater concern and a matter of a debate. Despite these doubts, most countries continue with capital account convertibility to integrate their financial markets with the rest of the world.

International capital flows affect most of the macroeconomic variables such as pace of economic growth, income level, domestic savings and investments, exchange rates and interest rates, price level and foreign exchange reserves, money supply and other domestic monetary conditions. Thus understanding the impact of capital flows and appropriate policy measures to protect against financial instability has become very crucial.

Before one takes a look at the empirical results of the studies on financial integration, it is imperative to take a look at the theory and see what theory has to say about the advantages and disadvantages of it and its linkages with many other macroeconomic variables. The chapter talks about these theoretical advantages as well as disadvantages of financial integration, its links with many other variables including social welfare and financial integration in developing country perspective.

### 2.2 Theory of Financial Integration

One can find the roots of financial integration in Solow’s model of economic growth, Mundell-Flaming model and Kuznet’s Inverted-U Hypothesis.

#### 2.2.1 The Mundell-Fleming Model

When the standard (closed economy) IS-LM model is extended to the open economy under perfect capital mobility, then it has a special name – 'Mundell-
Fleming Model\(^4\). The model is given by Sir Robert Mundell\(^2\) and Marcus Fleming\(^3\). This model portrays the short-run relationship between nominal exchange rate, interest rate and output in an open economy case.

The model shows that with perfect capital mobility, central banks cannot conduct an independent monetary policy under fixed exchange rates. This is commonly called as ‘Impossible Trinity’. According to this model, as domestic interest rate cannot move out of line with those prevailing in the world market; any attempt at independent monetary policy leads to capital flows and a need to intervene until interest rates are back in line with those in the world market. Thus the money supply is linked to the balance of payments. Surpluses imply automatic monetary expansion; deficits imply monetary contraction.

In the Mundell–Fleming open economy model with perfect capital mobility and fixed exchange rate, the monetary policy becomes ineffective. An expansionary monetary policy shifts the LM curve out resulting in increased income level and lower domestic interest rate. This leads to capital outflows from the economy. In case of fixed exchange rate system to maintain the exchange rate, the central bank would have to intervene in the market and sell foreign currency in exchange for domestic currency. The financial outflows offset the rise in the domestic money supply, and do not allow LM curve to shift to the right. Thus the domestic interest rate remains equal to the world rate of interest.

Under fully flexible exchange rates the absence of intervention implies a zero balance of payments. Any current account deficit must be financed by private capital inflows; a current account surplus is balanced by capital outflows. Adjustments in the exchange rates ensure that the sum of the current and capital accounts is zero. A second implication of fully flexible exchange rates is that the central bank can set the money supply at will. Since there is no obligation to intervene, there is no longer any link between the balance of payments and the money supply. This also implies that there is only one interest rate at which the balance of payments will balance i.e. when domestic interest rate is equal to world

\(^4\) Also known as IS-LM-BOP Model put forth by Sir Robert Mundell and Marcus Fleming independently in years 1963 and 1962 respectively.
\(^3\) Fleming, J. Marcus. (1962) "Domestic financial policies under fixed and floating exchange rates", IMF Staff Papers9: 369–379.
interest rate. At any other interest rate, capital flows are so large that the balance of payments cannot be zero.

Thus under managed floating exchange rate like India's, Mundell Flaming model implies that capital flows are linked to the current account balances. The current account surplus leads to capital outflows and the current account deficit implies capital inflows. This has long term impact on country's savings, investments and growth.

2.2.2 Neoclassical Theory of Growth

The neoclassical growth model, also known as the Solow–Swan 44 growth model or exogenous growth model explains long run economic growth in terms of productivity, capital accumulation, population growth and technological progress. According to the model, in the short run, the rate of growth is determined by the rate of capital accumulation and capital accumulation is determined by savings rate and the rate of depreciation of capital.

In neoclassical growth models, the long-run rate of growth is an exogenous variable, determined outside the model. According to the model an economy will always converge towards a steady state 45 rate of growth in the long run. This steady state rate of growth is determined by the rate of technological progress and the rate of growth in the labour force. Model also indicates that a country with a higher saving rate will experience faster growth. However, in the very long-run capital accumulation appears to be less significant than technological innovation in the Solow model.

This principle applied to the financial integration implies that financial integration, with efficient capital allocation and risk diversification enhances the savings and investment level in an economy, which in turn enhances economic growth in the short run. In the long run, financial integration will prove beneficial for growth only if it is accompanied by technological advancement and high quality human capital.


45 Robert Solow and Trevor Swan applied the term steady state in their economic growth model. In their model, steady state is a state of an economy when investment equals depreciation, and the economy reaches equilibrium, which may occur during a period of growth.
2.2.3 The Law of One price

The law of one price is an economic law which states that: "In an efficient market, all identical goods, assets, securities must have only one price". The law of one price (LOOP) also constitutes the fundamental principle underlying financial market integration. According to the LOOP, in the absence of administrative and informational barriers, the risk-adjusted returns on identical assets should be comparable across markets.

The law also states that the price of a given security, commodity or asset will have the same price when exchange rates are taken into consideration. The law of one price is another way of stating the concept of purchasing power parity. The law exists due to arbitrage opportunities. If the price of a security, commodity or asset is different in two different markets, then an arbitrageur will purchase the asset in the cheaper market and sell it where prices are higher. When the purchasing power parity doesn't hold, arbitrage profits will persist until the price converges across markets.

According to the neoclassical theory, international capital flows are induced due to the differences in expected rates of return on capital in different countries. Consequently, capital flows from developed countries to developing countries where productivity of capital is very high due to lower capital to labour ratio. This accelerates growth for some years and allows developing countries to run current account deficits. Thus capital flows can be used for consumption smoothing or for financing profitable investment opportunities. Thus according to the theory, perfect capital flows enhance global welfare due to efficient allocation of capital.

2.2.4 Kuznets hypothesis of the inverted U-shaped relationship between growth and inequality

A Kuznets' hypothesis and Kuznets curve show that as a country develops, there is a natural cycle of economic inequality driven by market forces which at first increases inequality, and then decreases it after a certain average income is attained.

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46 The law of one price (LOOP) is pioneered by Augustin Cournot (1927) and Alfred Marshall (1930).

Similarly, at the initial stages of financial integration, with the enhancing economic growth poverty also increases due to low levels of education and comparatively less opportunities for poor and lower income level. But, as financial integration matures, poverty decreases as poor are better equipped to deal with the opportunities provided by financial integration.

2.3 The Theoretical Advantages of Financial Integration

The process of financial liberalization opens the country to new forms and larger volumes of international financial flows and attracts capital flows. Then it leads to the liberalization of the terms governing outflows of foreign exchange to differing degree. These developments transform the structure of the financial sector and the nature and operations of financial firms.

Global financial integration involves direct and indirect benefits for the country following it. These benefits can be listed as follows: Enhanced capital flows have positive impact on domestic investment, savings and growth of a receiving country. Countries are benefitted in terms of international risk sharing and consumption smoothing. Countries are compelled to follow greater macroeconomic discipline and fiscal prudence. International financial integration could also positively affect total factor productivity. Financial openness may enhance the degree of development of domestic financial markets and lead to increased efficiency of the financial intermediation process. This lowers costs and excessive profits associated with monopolistic and cartelized markets, thereby lowering the cost of investment and improving the resource allocation. Influx of better technology generally associated with foreign direct investment and greater competition improves efficiency of domestic players. All these benefits have positive impact on growth and development of an economy.

However, the extent of benefits from financial integration is not same for all the economies. Countries tend to benefit only if they meet certain pre-conditions. Though it is true that many economies with a high degree of financial integration have experienced higher growth rates, financial integration with significant macroeconomic imbalances reduces net gains and raises the prospects of economic crisis. Empirical studies on international integration offer mixed perspectives on the benefits of financial integration.
According to the theory, the advantages of financial integration are as follows:

**Direct Channels**

**I. Expansion of Domestic Savings**

Financial integration is generally followed by large inflows of capital. Large capital inflows may result in a rise in real income; this in turn has a direct, positive but transitory effect on savings and savings rise. Financial integration also results in improved access to international financial markets and provides a wider range of saving instruments. This helps to channel funds into the formal financial sector from the informal sector resulting in increased savings. Inflows of capital also supplement domestic resources at a lower cost of capital.

**II. Higher Investments**

Interest rates are generally higher in capital-poor countries. Thus, capital-poor or developing countries provide higher returns on capital than what is available in capital-rich countries. Thus, financial integration-led capital flows lead to increased investment in capital-poor countries and benefit both the types of countries. Thus, if the marginal productivity of capital within the borders of the recipient country is higher than in the capital-rich regions of the world, financial integration results in higher investment as capital flows in to earn higher returns. This specifically allows higher rates of investment and economic growth without a greater sacrifice of current consumption in the recipient country. Besides, global diversification of risk can increase investment in the projects with higher expected return and high risk.

**III. Improved Capital Allocation**

International financial integration is believed to have two major potential benefits. One is, it improves the global allocation of capital and the other is, it helps countries to share risk in a better manner by reducing consumption volatility. Liberalization of trade in financial assets increase the number of potential investors, expand the size of the market, improves liquidity and market depth and increases efficiency in allocation of investments. The liberalization process allows for the development of a competitive financial system, which helps for the efficient allocation of resources by mobilising savings through the growth of financial intermediation and asset diversification.
Greater financial integration removes all obstacles to trading, clearing and settlement of financial assets and flow of capital. This helps firms to choose the most efficient trading, clearing and/or settlement options for the financial assets. Similarly, investors can invest their funds to its most productive use. More opportunities for productive investment will be available to the investors. This will result into the reallocation of funds to the most productive investment opportunities and efficient allocation of financial resources. Thus, financial integration helps the financial sector to allocate capital efficiently.

Financial integration leads to the investment of capital in the sectors that are expected to have high returns and withdrawal of it from sectors with poor prospects. It has been argued that in the course of financial integration, formal financial markets and associated institutions improve the capital allocation process and thus contribute to economic growth. Gourinchas and Jeanne [2004]\(^\text{48}\), however, has brought a simple neoclassical growth model into line and has found welfare gains from free international capital mobility between one and two per cent of GDP for capital-poor countries.

Capital accumulation is improved due to two reasons in the course of financial integration. Firstly, financial integration helps for the development of the stock market, which in turn leads to better capital allocation. Developed stock markets enclose more firm-specific information into individual stock prices. More informative prices help investors and managers distinguish between good and bad investments and leads to better allocation of resources. Secondly, in the course of financial integration, state ownership declines and capital allocation improves. Decline in the state ownership helps to eliminate politically motivated resource allocation, soft budget constraints and poor monitoring. This provides managers more incentives for efficient use of capital. Financial integration not only improves the supply of finance to growing industries, but also limits overinvestment in the declining industries and thus allocates capital efficiently.

IV. Risk sharing

Financial integration provides firms and households an access to international financial markets and helps to share financial risk. It increases the availability of

the sets of financial instruments and leads to the cross-ownership of assets too. This offers additional possibilities to diversify portfolios and share idiosyncratic risk across regions. Risk diversification possibly increases savings rates and gives foreign investors diversified access to high-risk high-return investment projects. This risk-sharing between savers and investors across borders can raise welfare and growth of the countries. Risk-sharing opportunities make it possible to finance projects with potentially very high return and high risk. As intermediaries specialise in the collection and dissemination of information, the allocation of resources can be performed more efficiently and at a lower cost. Project owners with low initial capital can turn to an intermediary that can mobilise savings so as to cover the initial costs. As financial integration increases the opportunities for investors, the creditors or debtors diversify their investment risks; it fosters financial stability by improving access to international capital markets. Van Wincoop (1994a) shows that ‘there are indeed large unexploited gains from risk-sharing, which amounts to a permanent increase in consumption between 1.7% and 5.6%’.50

V. Lower cost of capital owing to better risk allocation

Theoretically, capital market integration results in a lower cost of funds due to diversification and an increase in the supply of capital. Financial integration results into higher opportunities of risk-sharing between foreign and domestic investors. This leads to risk-diversification. Greater ability to diversify risk encourages firms to invest more and enhances growth. Increased capital flows enhance liquidity in the domestic stock market. This may reduce the equity risk premium further and thereby lowers the cost of raising capital for investment. Integration also removes certain forms of credit constraints faced by investors, because financial market integration and global institutions can handle credit risk better. The law of large numbers guarantees less exposure to credit risk as the

49 Idiosyncratic Risk is a risk that is specific to an asset or a small group of assets. Idiosyncratic risk has little or no correlation with market risk, and can therefore be substantially mitigated or eliminated from a portfolio by using adequate diversification.


51 According to the law of large numbers (a probability theorem), if a same experiment is performed a large number of times, the average of the results obtained should be close to the expected value, and will tend to become closer as more trials are performed. This is also applicable to the financial sector. This law was first introduced with proof by Jakob Bernoulli. [Jakob
number of clients increases. Hence, the integration into larger markets or even the formation of larger markets is beneficial to both firms and financial markets and institutions.

VI. Transfer of technology
Financially integrated economies seem to attract a large share of FDI inflows, which have the potential to bring in advanced technology from developed countries to developing countries and also pass on better management practices. These spillovers can raise aggregate productivity and in turn, boost economic growth.

VII. Consumption Smoothing
Financial integration also leads to consumption smoothing through risk-sharing. It helps domestic residents, firms, and countries to smooth away the fluctuations in their consumption or revenue by diversifying country-specific risks. When economic agents in different countries fully share risks, the consumption of agents in one country co-moves with that of agents located in other country and it is not correlated with country-specific shocks. Thus during recessions, countries can borrow from international markets and reduce the adverse impact of output decline on consumption and investment. Contrary during expansions, they can lend to other countries or pay back loans to counter the impact of expansionary pressures. Financial integration enhances the availability of the set of financial instruments available for international risk sharing, which can be utilized by domestic residents and firms for consumption smoothing and they receive large welfare benefits. Thus international financial integration results in potentially large welfare gains.

The ability to reduce fluctuations in consumption can enhance economic welfare. Generally output fluctuations are not correlated across countries and trade in financial assets can be used to separate national consumption levels from the country-specific output fluctuations. The scope for benefits from international risk sharing is larger when a country’s consumption growth is volatile and positively correlated with domestic output growth. Thus developing countries having highly

Bernoulli(1713) “Ars Conjectandi: Usum & Applicationem Praecedentis Doctrinae in Civilibus, Moralibus & Oeconomicis”, 1713, Chapter 4]
volatile income and consumption can gain large welfare through international risk sharing.

Prasad, et al [2003] have shown that ‘the estimated gains for the more integrated economies (which include India) exceed 2.5 per cent of GDP, while the gains for less financially integrated economies are about 6 per cent of GDP. These theoretical gains rely on consumption smoothing through financial integration\textsuperscript{52}.

They have also shown that more financially integrated economies have, on average, lower output volatility than lower financially integrated economies. Interestingly, there is a significant decline in average output volatility in the 1990s for both industrial and lower financially integrated economies but a far more modest decline for more financially integrated economies.

VIII. Development of financial sector

Financial integration has major indirect effects on economic growth through the promotion of financial sector development. A market-oriented financial sector contributes positively to economic growth of the country by providing access to external funding for firms, and by channelling investment towards growing and profitable industries and firms.

Financial sector development leads to economic growth through the following channels.

1. Financial Innovations

Financial openness demands financial innovations. Financial innovations like derivatives and other risk management products widen and deepen the financial markets leading to financial development. These innovations enable the financial system to provide for the spreading and distribution of risks and allow economic agents to identify and to separate specific risks in their portfolio and manage them individually using a wide variety of hedging products. This enhances financial intermediation by lowering costs and by lowering excessive profits associated with monopolistic or oligopolistic markets. Lower cost of financial intermediation thus, lowers the cost of investment and improves resource allocation, which ultimately leads to growth.

2. Development of a Stock Market
Financial liberalization measures like removing restrictions on international portfolio flows tend to enhance stock market liquidity. Improvements in stock market liquidity accelerate economic growth primarily by boosting output productivity. Lower barriers to international investments will also boost equity market development and promote economic growth through lower production and consumption volatility in the domestic market. Stock market liberalization improves the risk allocation and helps economy to grow faster.

3. Impact upon the Banking Sector
Large capital inflows increase the foreign liabilities of the banks and may affect the banks' balance sheets. Thus banks are exposed to risks related to interest rates, currency, country, maturity as well as asset-liability mismatches. Higher inflows may cause a rise in the growth of private domestic credit, lending boom and risky loans. Policy intervention may help to limit the extent of intermediation of the capital flows through the banking system. Policy intervention both in form of capital outflows matching current account deficit or sterilization of the inflows by central bank will reduce the exposure of banks and their risks. Both these interventions will prevent an expansion of domestic credit and related effects. ‘A rise in net capital inflows may lead to a rapid expansion of the commercial bank sector, as has been observed in Thailand and Indonesia’.

IX. Development through Foreign Banks Participation and Greater Competition
Financial integration leads to increased foreign ownership of domestic banks and increased foreign ownership of domestic banks in turn generate a variety of benefits. Foreign bank participation can facilitate access to international financial markets. It helps to improve the regulatory and supervisory framework of the domestic banking industry. The entry of foreign banks tends to increase competition. Increased competition in the domestic financial market can improve the quality of domestic financial services as well as improve allocative efficiency by allowing foreign banks to introduce a variety of new financial instruments and techniques and also foster technological improvements in domestic markets.

Increased competition by foreign banks is associated with the wide spread of new technologies. Foreign institutions improve the quality and availability of financial services by bringing in new and better skills, management techniques, training procedures and technology. Foreign banks can introduce new technological innovations that foster credit to small and medium-sized firms. Improving the quality of domestic financial services also make these financial systems more attractive. Thus enhancing participation from local and foreign agents contributes to further development of these financial systems.

Greater foreign bank presence leads to lower bank profits and bank overhead costs. Presence of foreign banks enhances competition and makes banking sector more efficient. Increased number of foreign participants put pressure on domestic banks to reduce excess overhead costs and accept lower profits. Thus greater foreign bank presence enhances the efficiency of the domestic banking system and better developed banks in turn spur economic growth by accelerating productivity growth.

Foreign banks themselves follow sound prudential practices and force domestic banks to follow the same. Further foreign banks help for the development of supplementary institutions that promote the information flow about firms. This leads to the development of better rating agencies, accounting standards and credit bureaus that acquire and process information, as well as better bank supervision and a more adequate legal framework. More aggressive provisioning standards and higher capital ratios in turn ensure the future stability of the financial system.

Financial integration-led-foreign bank participation improves financial stability by increasing the number of financial intermediaries and the removal of barriers to free trade. Global institutions can better reap the benefits of an expanded and integrated market and can also better withstand potential shocks than local financial institutions. Credit volatility can be reduced by foreign banks. Having access to foreign liquidity, foreign banks are less dependent on unstable local deposits, and therefore can stabilize credit in the host country. Moreover, the good reputation of many foreign banks allows "depositor-flight-to-quality"54 to occur.

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54 Flight-to-quality refers to a sudden shift in investment behaviour in a period of financial turmoil whereby investors seek to sell assets perceived as risky and instead purchase safe assets. A defining feature of flight-to-quality is an insufficient risk taking by investors. While excessive risk taking can be a source of financial turmoil, insufficient risk taking can severely disrupt credit and other financial markets during a financial turmoil. Such a portfolio shift further exposes the financial sector to negative shocks. An increase in leverage and credit spread on all but the safest
within the domestic market during financial turmoil, stabilizing both deposits and credit.

Most foreign banks seeking presence in other markets tend to be better at resource allocation and overall efficiency. Thus, liberalization of restrictions of foreign capital and foreign banks tends to enhance the overall functioning of domestic financial system, which in turn stimulates improvements in resource allocation and foster economic growth.

X. Reduced Vulnerability to Domestic Shocks

Financial integration allows residents to hold an internationally diversified portfolio which reduces the income and wealth vulnerability to domestic shocks. It facilitates efficient trading, hedging, diversifying and pooling of risk; efficient resource allocation and savings mobilization. In addition to lower economic uncertainty, this enables lower cost of funding for borrowers and allows high yield prospects to savers. International portfolio diversification achieves economic growth through capital and technological accumulation and it achieves economic welfare through consumption smoothing.

Indirect Channels

I. Inducement for better policies

Financial integration may induce countries to follow more disciplined macroeconomic policies by increasing the penalties for bad policies and the rewards of good policies. This leads to greater macroeconomic stability.

Financial integration can aggravate the risks associated with imprudent fiscal policies. In the course of financial integration, imprudent fiscal policies may lead to excessive borrowing, unproductive government spending, and large amounts of short-term debt denominated in hard currencies and increased vulnerability to external shocks. The experiences of a number of financially integrated countries that have suffered the consequences of external debt accumulation point to the increased risks of undisciplined fiscal policies when the capital account is open. An unsatisfactory fiscal policy destroys credibility gradually and may induce capital flight.

and most liquid assets may incur a sudden dry up in risky asset markets, which may lead to real effects on the economy.
Financial integration enhances the effectiveness of fiscal policy as it reduces real interest rates of public sector borrowing, reducing the inflation tax and the rates of other taxes to international levels and thereby enhancing tax revenues. It also reduces crowding out effects. Similarly, consistent and coordinated macroeconomic policies may substantially enhance the benefits of capital account convertibility.

International financial integration forces government to follow disciplined and prudent future policies and increases productivity in an economy. This financial integration-led-fiscal discipline may lead to a reallocation of capital towards more productive activities in response to changes in macroeconomic policies. Thus, prudent fiscal policy helps to channelize capital flows into productive investments.

Financial integration also underlines the need for flexible exchange rate regime. The inflexible exchange rate system cannot bear the burden of financial integration as capital flows put lots of pressure on the exchange rate and it becomes difficult for monetary authorities to maintain the exchange rate at the fixed level. Thus, developing countries attempting to maintain a relatively inflexible exchange rate system often face the risk of attacks on their currencies. Financial integration, inflexible exchange rate and the absence of supportive domestic policies can often result in an abrupt reversal of inflexible exchange rate, when adverse shocks hit the economy.

In an international sphere, country’s willingness to undertake financial integration is interpreted as a signal that the country is going to practice more friendly policies towards foreign investment in the future. Thus removal of restrictions on capital outflows can lead to an increase in capital inflows by signalling willingness for financial openness. Many countries— including Colombia, Egypt, Italy, Mexico, New Zealand, Spain, the United Kingdom, and Uruguay— have received significant capital inflows after removing restrictions on capital outflows.

Financial integration demands a strong discipline from the financial system and requires more proactive policy action. Financial integration also enables a merger of domestic financial prices with international levels and this provides the impetus

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for domestic tax regimes to rationalise and converge to international tax structures. It restricts domestic agents from evasion and capital flight. Financial integration also leads to the regulatory independence and avoidance of regulatory arbitrage. Financial integration increases the number of participants and changes interests governing the financial system and will lead to independent policies. Furthermore, in a financially integrated system, regulatory principles are driven by international principles that are likely to be less influenced by domestic interests. Financial integration leads to growth provided that there are good macroeconomic policies and good domestic governance. Countries with good human capital and good governance attract more foreign direct investment, and it leads to growth. The quality of macroeconomic policies and domestic governance determine the vulnerability of a developing country to the risk factors associated with financial globalization. An overvalued exchange rate and an overextended domestic lending boom often precede a currency crisis. In addition, lack of transparency is seen to be associated with more herding behaviour by international investors, which can destabilize a developing country’s financial markets. A high degree of corruption also may affect the composition of a country’s capital inflows and makes it more vulnerable to the risks of speculative attacks and contagion effects. Thus, the ability of a financially integrated country to derive benefits from financial globalization and its relative vulnerability to the volatility of international capital flows can be significantly affected by the quality of its macroeconomic framework and its institutions.

II. Promotion of specialization

Financial globalization promotes international risk sharing. Financial integration-led-risk sharing will encourage specialization of production indirectly and increases growth rate.

56 Arbitrage is a practice whereby firms capitalize on loopholes in regulatory systems in order to circumvent unfavourable regulation. Arbitrage opportunities may be accomplished by a variety of tactics, including restructuring transactions, financial engineering and geographic relocation. Regulatory arbitrage is difficult to prevent entirely, but its prevalence can be limited by closing the most obvious loopholes and thus increasing the costs associated of circumventing the regulation.
In the absence of risk management mechanism, a highly specialized production structure may lead to high output and consumption volatility. Increasing volatility poses obstacles in adopting growth-enhancing specialization activities. Higher volatility also implies lower saving and investment rates. In contrast, financial integration provides a better mechanism for risk sharing and encourages growth-enhancing specialization activities.

The relationship between financial liberalization and economic growth is complex, not only because there are short-term and long-term effects involved, but also financial liberalization is a process with many interrelated dimensions. The above discussion indicates that there are number of channels through which international financial integration can promote economic growth in developing countries directly and indirectly.

Higher investments, higher savings, efficient allocation of capital, lower cost of capital, better and greater avenues of risk sharing, access to advance technology and efficient management techniques all lead to growth. Consumption smoothing is also a great advantage of financial integration. The links like the development of the financial sector and financial deepening are very strong in many countries. Increased competition with foreign entities and inducement for better policies are also conducive to growth.

2.4 Disadvantages of Financial Integration

Though there are many benefits associated with financial integration in theory, this multifaceted and complex phenomenon shows mixed results in practise. International financial market integration may prove beneficial in the long term, but it a high degree of financial openness may have heavy short-term costs as well.

Potential costs of financial integration include the highly concentrated capital flows and misallocation of flows having adverse impact on growth; macroeconomic instability; the pro-cyclical, volatile and short-term capital flows, sudden reversals of capital flows followed by herding and contagion effects; and risks associated with foreign bank penetration. This may lead to macroeconomic instability, unsustainable levels of consumption and spending, rapid monetary expansion, inflationary pressures, exchange rate appreciations and widening current account deficits. Furthermore, there are some significant negative
economic and social effects of financial liberalization, which often significantly outweigh any benefits in terms of access to more capital inflows.

I. Lower Savings
Interest rate liberalization affects financial savings positively and leads to financial deepening; but it may not necessarily increase domestic savings. Generally, financial integration may boost external borrowings, in which case the domestic level of savings goes down. If liberalization leads to lower interest rates then it may also have negative impact on savings. Financial liberalization encourages new kinds of financial savings, but total domestic savings may not increase. Thus, higher financial savings are the result of higher capital inflows and not of increase in domestic savings.

II. Lower Investments and Inefficient Capital Allocation
Financial liberalization may also not necessarily result in intermediation of financial assets with long-term maturities, as deposits and loans of short duration become dominant. Though stock markets experience short booms, there tends to be relatively little mobilization of new capital or capital for new ventures. In fact, small investors tend to withdraw from markets as a result of allegations, manipulation and fraud. Thus, investment does not usually reflect signs of improved performance or more efficient allocation. External financial liberalization and associated capital inflows, only aggravates these consequences. It is difficult to rely on external finance due to the prevalence of short term and unstable capital flows and the substantial subsequent adjustment costs. It has been observed that as a result of the debt crisis in 1982, investors in industrial countries avoided the countries having heavy borrowings until the year 2000. Thus, increased risk aversion discourages new investments. Capital outflows from crisis-hit countries have been observed to have increased significantly.

As it has been observed, all capital inflows are not necessarily productive. Particularly, foreign direct investment (FDI), and not all the FDI but a part of it has been found to be productive. FDI that enhances production of a host country for meeting the global market or FDI that produces goods essential for the host country but for which country lacks the technology are supposed to be productive. FDI that produces goods for the home market and that just replaces what is being already produced does not add to the productive capacity. This causes an implicit
form of de-industrialization. All the capital flows in form of deposits or portfolio investments constitute short-term and essentially speculative capital flows that do not add directly to productive capacity.

In practice, it has been observed that financial liberalization has failed to attract productive capital flows. The share of FDI to the developing countries is limited. The share of productive or non-de-industrializing capital inflows is even meagre. Besides, all liberalised economies are chasing this meagre amount. This ultimately leads to the limited productive capital flows to the developing countries. This exposes the economy to the speculative capital flows.

Exposure of the economy to short term and speculative capital flows may cause deflationary policies in general and slows down the growth rate of the economy. This affects the magnitude of social expenditure adversely. It may expose the economy to the crisis. This passes key domestic resources and means of production into foreign hands. Finally, it nullifies sovereignty and undermines democracy.

Other things remaining constant, capital tends to move from the backward economies to the advanced capitalist countries in the course of free flow of capital. Generally, capital enjoys greater safety, greater social stability and less of a threat to its supremacy in advanced capitalist countries. To attract more capital in the free capital market, developing countries tend to keep domestic interest rate high. Therefore, financial liberalization is inevitably associated with an increase in interest rates compared to what prevailed earlier and with higher interest rates than in the advance capitalist countries. The increase in interest rates has an adverse effect on productive investment directly as well indirectly. The servicing of public debt becomes more expensive. It limits the public treasury and leads to lower public investment. It decreases private investment via the demand and supply constraints. The limit on the public treasury also affects welfare expenditures adversely. This can be averted by either raising larger tax revenue or by running a larger fiscal deficit. But in a financially integrated economy, neither of these options is possible.

III. Increased Interest Rates
In course of free capital flows, capital scarce countries or developing countries always tend to keep interest rates higher; higher than what prevails in the
developed countries to attract more capital flows. Greater exposure to volatile shocks, increased risk of default and lower domestic output may even translate into higher domestic interest rates in developing countries too. Higher volatility of world interest rates increases expected intermediation costs and leads to higher domestic interest rates or to credit rationing to maintain expected profits. Financial openness may also have adverse effects on growth and on poverty through greater exposure to volatility and increased interest rate. On a positive side, higher real interest rates encourage larger savings and hence larger investment ratio without causing higher rates of inflation.

IV. Pro-cyclical Capital Flows and Consumption volatility

Financial openness generally leads to asymmetric access to world capital markets. Many countries can borrow only in good times, and may face credit constraints in bad times in world capital markets. Thus access to capital is pro-cyclical. Pro-cyclical access to world capital markets reduces the ability to borrow for consumption smoothing. Favourable shocks may attract large capital inflows and encourage consumption and spending at unsustainable levels in the longer term. This may force countries to over-adjust to adverse shocks as a result of abrupt capital reversals. Capital flight may result into the lower rate of accumulation of domestic capital and may lead to persistent, adverse effect on growth in the presence of increasing returns driven by externalities in knowledge and capital formation. Pro-cyclicality may also increase macroeconomic instability.

V. Currency Appreciations

Financial integration-led-capital inflows may also appreciate exchange rate of a country. In many instances, large capital inflows increase domestic money supply, leading to inflation and currency appreciation. This makes imported goods cheaper, exports costlier and encourages consumption. This may also lead to current account deficits. Large capital inflows may also increase the domestic expenditure. Increased domestic expenditure increases the demand for the tradable as well as non-tradable goods. This increases imports and widens trade deficit. Exchange rate appreciation takes place through a nominal appreciation with a floating exchange rate and no central bank intervention. In a fixed exchange rate economy, large
capital inflows cause an expansion in the domestic money supply, increase in aggregate demand and the prices of non-tradable goods and services. This ultimately leads to the currency appreciation. Real appreciation of a currency causes the loss in external competitiveness, and reduces exports. This reduces the profitability of the exporting sectors of the economy and disrupts the process of trade liberalization.

VI. Concentration of Credit
Greater presence of the foreign banks in the domestic financial system followed by financial integration has certain disadvantages. A greater penetration of foreign banks may lead to concentration of credit with large firms. It also affects the access to loans by small and medium size firms adversely. As small and medium size firms are comparatively more labour intensive, it has adverse implications for employment and income generation. This leads to lower levels of economic activities, lower demand for labour and a greater incidence of poverty and unfavourable income distribution. Thus, the emergence and rise of oligopolistic tendencies due to the association of financial intermediaries and non-financial corporations is the result of financial liberalization in imperfect markets. Market signals play dominant role in determining the allocation of investible resources in case of unregulated financial sector or financial sector with minimum regulations. This may direct credit to non-priority and import-intensive but more profitable sectors. This causes concentration of investible funds with few large firms which are already well-developed centres of economic activity. Alternatively, the financial system in the more financially developed regions may overtake all or parts of the intermediation process in the least financially developed regions. This leads to the lopsided development of the world financial markets. At the same time, as there is a concern that financial integration could result in a wave of consolidation that might hamper the efficient process of financial intermediation.

VII. Vulnerability of Economies
It has been observed that many countries are becoming more and more vulnerable to many domestic as well as international financial disturbances in the course of international financial integration. Post financial liberalization, many developing
countries have become increasingly dependent on borrowing from foreign banks or foreign portfolio investment. This has even increased the risk of sudden stops of capital inflows to developing countries or abrupt reversals of these flows. These capital flows are very sensitive to domestic conditions in the recipient countries as well as to macroeconomic conditions in industrial countries.

At the times of crisis, countries cannot borrow from international capital markets to cover large deficits, as they face external financing constraints. Thus, countries are forced to rapidly generate current account surpluses to meet crisis-induced capital flows abroad. This enhances the vulnerability of economies with large foreign currency liabilities to exchange rate overshooting. Generally, the policy options for macroeconomic stabilisation available to crisis-hit countries are very few. This has led to more flexible exchange rate regimes in recipient countries as well as holdings of more foreign exchange reserves.

VIII. Volatility

Though financial globalization may provide better opportunities for reducing volatility through diversifying risk, recent crises in some economies have shown that financial integration in fact has increased volatility. Financial integration may result into three kinds of volatilities—volatility of capital flows, volatility of consumption and volatility of output, which may lead to macroeconomic volatility.

1. The volatility of capital flows

Amongst various types of capital flows, financial flows in form of equities or FDI are the most stable capital flows. Portfolio investment tends to be more volatile and pro-cyclical in nature and the most unstable source of finance is cross-border bank lending. At the time of crisis, these bank-intermediated flows fall sharply and often remain depressed for several years. Portfolio debt flows also drop but tend to recover relatively quickly.

Financial or monetary shocks in investor countries can greatly destabilise capital movements in emerging markets. A high degree of volatility of capital flows leads to herding and contagion effects whereas shock in one emerging country can lead foreign investors with limited local knowledge to indiscriminately withdraw from several countries. Moreover, access to international capital markets has a pro-
cyclical element, which tends to generate higher output volatility as well as excess consumption volatility.

The absence of sound financial regulation, both at the national and international levels and the absence of institutions with the ability to manage greater volatility make developing countries much more vulnerable to negative impacts of capital flows. Generally pro-cyclical nature of international capital flows adds to the ill-effects of fiscal and macroeconomic policies. Such pro-cyclical behaviour deepens and prolongs a crisis.

The volatility of FDI, banking flows and portfolio flows affect the size and the competitiveness of the domestic banking system negatively. The volatile portfolio flows affect the depth of the domestic stock markets negatively. Generally, policymakers are reluctant to rely on external finance due to highly volatile nature of capital flows and the substantial subsequent adjustment cost.

Actually the unstable capital flows creating the currency mismatches and short duration debt structures have played a key role in almost all financial crises affecting the Emerging Market Economies in the 1980s and the 1990s.

2. Consumption Volatility

Financial liberalization in developing countries may lead to higher consumption volatility and increased GDP volatility.

'As consumption is considered a better measure of wellbeing, fluctuations in consumption have negative impacts on economic welfare. In good times, financial integration in developing countries leads to positive productivity and output growth shocks which in turn lead to consumption booms that were willingly financed by international investors and when negative shocks hit these economies, they rapidly lose access to international capital markets. Low to moderate levels of financial integration may lead to greater volatility of consumption relative to that of output. The increase in the ratio of the volatility of consumption to that of income for the MFI (Moderately Financially Integrated) economies in 1990s suggests that financial integration has not provided better consumption-smoothing opportunities for these economies'.

It has been observed that, beyond a particular level, financial integration significantly reduces consumption volatility, i.e. an important threshold effect has

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been identified in case of impact of financial integration on consumption volatility\textsuperscript{58}. Most of the developing economies are either low financially integrated or moderately financially integrated. Thus, these developing countries are below this threshold and face increasing consumption volatility with the increasing financial integration, but up to a certain threshold. Beyond this threshold, countries experience the benefits of financial integration in terms of improved risk-sharing and consumption-smoothing.

3. **Output Volatility**

Theoretically, there are mixed effects of financial integration on output volatility. On the one hand, financial integration provides access to capital which helps capital-poor developing countries to diversify their production base. On the other hand, rising financial integration also leads to increasing specialization of production based on comparative advantage principle, making economies more vulnerable to industry-specific shocks.

In developing countries, a combination of less developed domestic financial sector and greater trade openness generally leads to higher output volatility. In contrast, a higher degree of financial integration is associated with lower output volatility in case of OECD countries, as more developed financial sectors are able to reduce output volatility through financial integration.

Though not consistent, empirically there is a significant positive association between the volatility of capital flows and output volatility.

4. **Macroeconomic Volatility**

There is a complex relationship between international financial integration and macroeconomic stability. Contrary to the theory, the developing countries particularly have faced greater macroeconomic volatility in the course of financial integration. In these countries, financial linkages have the potential to aggravate the effects of both real and financial shocks and thus the process of capital account liberalization has often been accompanied by increased vulnerability to crises.

Premature opening of the capital account also poses serious risks in the presence of inadequate financial regulation and supervision. With the weakly regulated banking system and distorted domestic capital markets, inflows of foreign capital aggravate the existing inefficiencies in the economies. If domestic financial

\textsuperscript{58} ibid.
institutions tend to channel capital to firms taking excessive risks or having weak fundamentals, existing inefficiencies aggravate. Weak macroeconomic fundamentals also force countries to borrow at shorter maturities.

Opening of the capital account has made the stock markets more vulnerable to the vagaries of cross-border movements of capital. Portfolio flows if intermediated through the banking system have a greater impact upon domestic monetary expansion. Sudden and uneven increases in intermediated funds will lead to an irregular expansion in the volume of domestic financial assets and liabilities. The volume of bank lending is bound to rise and could lead to unethical and improper lending, if they are not sterilized. This may trigger a consumption boom when consumption or real estate is financed. Moral hazard risks are thus likely to increase, threatening financial instability.

The progressive integration of financial markets and consequent increase in the frequency of capital inflows and outflows out of the country can increase the risk of volatility. A rise in volatility can have a destabilising effect especially if financial markets are thin as in case of developing countries. This can also lead to large variations in market liquidity, which can lead to higher volatility.

IX. Possibility of Crises

Financial crises have the worst possible impact of financial integration. The financial crises in many emerging economies have increased the doubts about the net benefits of capital account liberalization for developing countries. The liberalization of developing countries with financially repressive systems may lead to heavy capital inflows followed by sudden reversals and financial crises. Such crises are detrimental to economic growth. The experience with capital account liberalization indicates that the benefits out of financial liberalization depend upon the vulnerability of liberalized economy to financial crisis.

Financial integration-led-heavy capital inflows may appreciate exchange rate. A real exchange rate appreciation encourages investment in non-tradable sectors and discourages investment in tradable goods and services, i.e. it increases investment mostly in real estate and in domestic asset markets and discourages investment in tradable goods and services. This may lead to deindustrialization in developing countries. Thus, even when the real economy may have been stagnating or declining, most of the emerging market economies experience substantial
financial capital inflows and property and real estate booms as well as stock market booms. These booms generate the incomes to keep domestic demand and growth in certain sectors growing at relatively high rates. This soon results in macroeconomic imbalance, i.e. a current-account deficit reflecting the consequences of debt-financed private extravagance.

With a substantial exposure to international capital, any small factor of economic setback can induce a heavy outflow of capital. An unusually high outflow of capital from the market can impact the value of the rupee adversely and set off speculation in the currency that may result in a currency crisis. The current-account deficits are generally followed after the capital-account surpluses and may lead to crisis.

When developing countries open up their financial regimes to international markets, relatively underdeveloped financial systems get pushed towards a poorly regulated, oligopolistic structure, with a corresponding increase in fragility. Greater freedom to invest, to include sensitive sectors such as real estate and stock markets, ability to increase exposure to particular sectors and individual clients and increased regulatory forbearance all lead to increased instances of financial failure. Thus, it has been widely observed that financial liberalization has resulted in an increase in financial fragility in developing countries, making them prone to periodic financial and currency crises. Financial liberalization and access to foreign capital inflows in emerging markets, in the presence of inadequate prudential regulation, supervision and enforcement also leads to the increase in the potential volatility of bank deposits and deterioration in the banking system and eventually to banking crisis. Herd instinct and informational externalities are two more factors which lead to failures in financial markets.

These crises have had a considerable impact on GDP and long-term growth prospects. Labourers also suffer heavily in times of crises with a fall in the labour share in national income during these times. Sudden and large reversals of capital inflows at the time of crises lead to the contraction of domestic consumption or investment or both.

The recent experiences of crises in emerging market economies imply that sustainable fiscal policies, financial reform and regulatory improvement and regulatory forbearance is regulators' refraining from exercising their right to put an insolvent bank out of business.
flexible exchange rate regimes reduce the likelihood of capital account crises. The accumulation of official reserves from capital inflows will reduce the impact of a capital account reversal if it should occur. Imposing selective capital controls is another but costly way to reduce the probability of crises.

Sterilization (which is used as a measure to avoid exchange rate appreciation and its ill-effects) by the central bank enlarges liquidity in the economy. This may either lead to an expansion of luxury consumption or an expansion of investment in the domestic non-tradable sector such as real estate, or for financing speculative booms in asset markets, especially the stock market. Short-term capital outflows may cause a downward pressure on the exchange rate and a collapse of asset prices, which reinforce one another, and cause a sudden outflow of capital. A policy of interest rate increase to control capital outflows, leads to a contraction of the real economy. Thus, the withdrawal of short-term funds does affect the real economy adversely. These outflows can be sudden, concentrated, and extremely destabilising, causing acute misery to the people.

Real effects of intermediated foreign capital depend pretty much upon what these loans finance. For example, in the ASEAN region and some Latin American countries, like Chile and Mexico, capital inflows have been associated with high domestic savings, investment and economic growth. Absorption was therefore smooth and did not disrupt macroeconomic stability. However, in the Latin American region, particularly Argentina and Brazil, there was a rise in private consumption. Instances when inward foreign capital translated into a stock market and real estate boom that ultimately ended in a financial or currency crisis, as in Malaysia and Thailand, are also well known.60

X. Contagion Effect

A major risk of financial market integration is that of contagion. Increasing cross-country financial market correlations, shallow and undiversified stock markets, excessive international capital flow volatility, international investors’ tendency to engage in herding behaviour and forceful trading have increased the risk of financial market bubbles and are responsible for the crises in emerging markets and contagion effect.

Financial crisis in one country is transmitted immediately and easily to other emerging market countries (even to those countries which do not exhibit major macroeconomic imbalances). There are two channels through which the contagion normally works. One is the real channel, which leads to the domino effects\textsuperscript{61} on participants operating in other segments. The other is the information channel which relates to contagious withdrawals due to lack of accurate and timely information. Increased domestic and international integration increases the risk of contagion as problems in one market segment are likely to be transmitted to other markets with the potential to cause systemic instability.

Financial firms which want to reduce or avoid monitoring costs may just follow other firms, and more particularly, larger financial firms in making their investments. This leads to the herd behaviour of financial players. This not merely limits access to finance for some agents, but could lead to overlending to some entities. The prevalence of informational externalities can create other problems. Malpractice in a particular bank leading to failure may trigger fears among depositors in other banks, resulting in a deposit run. Loans for investments in stocks or real estate can be at extremely high interest rates, because the returns in these sectors are extremely volatile and can touch extremely high levels. Since banks accept real estate or securities as collateral, borrowing to finance speculative investments in stock or real estate can spiral. This type of activity prosper because of the belief that losses if any can be transferred to the lender through default, and lenders are confident of government support in case of a crisis. This could feed a speculative spiral that can in time lead to a collapse of the bubble and bank failures.

Generally, the effects of real shocks are aggravated and transmitted faster through financial channels. Since transmission through financial channels is much quicker than through real channels, both the speed and magnitude of international effects of real shocks are considerably deepened by financial linkages. Cross-country investments flows have responded quite strongly to country-specific shocks and have resulted in contagion effects.

\textsuperscript{61}The domino effect is a chain reaction that occurs when a small change causes a similar change nearby, which then causes another similar change, and so on in linear sequence or it is a situation in which one event causes a series of similar events to happen one after another. It typically refers to a linked sequence of events where the time between successive events is relatively small.
XI. Costly Reserve Accumulation and Sterilization

Financial openness has led developing countries to engage in costly reserve accumulation on an unmatched scale. Developing countries have been increasingly building up foreign reserves as it provides some protection against financial crises and against the instability of the current international financial system. Some countries have accumulated these reserves by surplus on the current account, while others built up reserves through capital inflows which were not spent on foreign goods. Holding large international reserves provides some protection against financial crises; but it is an expensive strategy as foreign reserves are held in low interest bearing instruments such as US treasury bills, rather than earning higher returns on the capital market or through investment into human or physical capital. Thus accumulation of reserves can have indirect negative effect on growth. A larger amount of foreign reserves reduces income and growth potential, but holding an adequate level of reserves, along with other policy instruments, is necessary to enable the central bank to respond quickly to short-term capital inflows and outflows.

Accumulated reserves impose costs on developing countries; however they prove to be an indirect subsidy to the countries in whose currency the reserves are held. A very disturbing fact is that this trend is on a rise.

Baker and Valentin (2001) estimate that 'the increased reserve level of the late 1990s compared to that common in the 1960s implies an annual cost of around 1 per cent of GDP in most regions and of between 1.2 and 2.5 per cent in East Asia and the Pacific. They argue that the gains of trade liberalization in terms of higher GDP growth were actually "eaten up" for most countries in the 1990s by the earning forgone on holding higher reserves'\(^62\).

'It has been observed that reserves held by low- and middle-income countries have increased threefold between the early periods 1990's (6.9 per cent in the first half of the 1990s) and 2000s (equal to 20.7 per cent of their GNI in 2004)'\(^63\).

Sterilization is also used to limit the impact of foreign currency inflows upon domestic money supply. There is a greater need for sterilization in the presence of

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a fixed exchange rate regime. Since sterilization involves an exchange of foreign currency assets for domestic currency assets, the domestic interest rate has to be kept high to limit central bank's losses arising out of interest differentials. However, this may attract further capital inflows, which can be potentially destabilising in some situations. It may even lead to an increase in public debt and substantial sterilization costs due to a favourable interest differential for domestic bonds. Sterilization may exert pressure on short-term interest rates through open market operations too. One drawback of the sterilization through reserve requirement changes is that it is not effective in addressing capital inflows, which are intermediated outside the banking system, i.e. bond and equity markets. The more developed the non-financial sector, the less effective will be sterilization policy through standard open market operations or through reserve requirement changes. Other costs of sterilization through reserve requirement are the low rates of return that reserves earn, which distorts the share of intermediation by the banking sector. Another source of loss to the central bank due to sterilization is the interest differential between the interest rate on purchase of foreign exchange securities and the interest rate paid on external debt servicing.

XII. Macroeconomic Imbalances

There is a mutual relation between macroeconomic imbalance and financial liberalization. Initial macroeconomic imbalances are responsible for post-integration crisis and financial integration also may result into macroeconomic imbalances. All the financial crises and particularly Asian crisis in mid-1997 have underlined the importance of sound macroeconomic policies in the presence of liberalized financial flows.

In an internationally integrated market, it is not possible for the countries to control the amount of capital inflows or outflows. Both these capital movements can create undesirable consequences. If a country is suddenly chosen as a preferred destination for foreign portfolio investment, it can lead to huge capital inflows which in turn cause the currency to appreciate, thus encouraging investment in non-tradable goods and services rather than tradable goods and services, and altering domestic relative prices and therefore, the incentives.

Unless stored in form of accumulated foreign-exchange reserves, the inflows of capital lead to current-account deficits. Therefore, large current account deficits
are necessary by-products of the surge in capital inflows. When the current-account deficits become unsustainable, it creates the conditions for their own reversal. That means, once there are completely free capital flows and complete open access to external borrowing by private domestic agents, a country cannot follow prudent macroeconomic policy. The overall domestic balances or imbalances will change according to the behaviour of capital flows, which in turn respond to the economic dynamics that they have set into motion.

XIII. Decrease in Government Revenues and Spendings and Deflationary effects

Developing country government’s priority to attract international capital flows limits the possibilities of enhancing taxation, especially on capital. Trade liberalization reduces the indirect tax revenues of states. Thus Tax-GDP ratios often deteriorate in the wake of financial liberalization. This in turn, imposes limits on government spendings. Capital inflows are also generally not in favour of large fiscal deficits, as such deficits force the state to reduce its expenditure. This not only affects the possibilities for countercyclical macroeconomic policies of the state but also reduces the developmental or growth-oriented activities of the government.

Financial integration also limits deficit-financed spending by the state. Firstly, deficit financing is inflationary in nature and it reduces the real value of financial assets. Secondly, government’s deficit financed spendings are autonomous and distorts the financial markets. Lastly, the presence of the state as regulator and the state’s interventionist activity put the limits on the role of finance and financial markets tend to prefer controlling government deficits. Thus, financial liberalization forces the state to adopt deflationary macroeconomic policies to serve financial interests and these deflationary tendencies adversely affect real investment.

Efforts to curb the fiscal deficit involve a contraction of public expenditure, more particularly expenditure on capital formation. This adversely affects growth and employment. It leads to a curtailment of social sector expenditures. It has adverse impact on food and other subsidies that benefit the poor. In India, the finance-induced pressure to limit deficit spending is institutionalised through a legislation - the Fiscal Responsibility and Budget Management Act, 2004. This
constitutionally binds the state to do away with revenue deficits and limit fiscal
deficits to low, pre-specified levels.

XIV. Credit Crunch for Priority Sectors
Financial integration also reduces the availability of credit to the socially and
economically crucial sectors. This certainly affects employment-intensive sectors
such as agriculture and small-scale enterprises. These are the sectors, where
collateral is not easy to ensure and there is a high risk element. This results into
very high transaction cost of lending in these sectors. Thus, these sectors face
lower credit availability in the course of financial integration and socially
desirable role of financial intermediation becomes fruitless. The crisis in
agriculture sector in most parts of the developing world is related to the decline in
the access of farmers to institutional finance, which is the direct result of financial
liberalization.
The late industrializing countries have deliberately developed strongly regulated
and predominantly state-controlled financial markets to mobilize savings and to
influence the size and structure of investment as per their development needs.
Financial structures were therefore purposefully developed to deal with the
difficulties in late industrialized countries through directed credit policies and
differential interest rates, and the provision of investment support to the budding
industrial class in the form of equity, credit and low interest rates. Financial
integration needs to dismantle these financial structures, which has dampening
effects on production structures and growth.
The gradual phasing out of subsidized credit programs may also increase financial
constraint of certain types of firms that were previously benefited from the
directed credit regime.

XV. Negative Impact on Growth
In theory, there is a strong and direct relationship between financial integration
and growth. Successful implementation of financial liberalization boosts
economic growth whereas unsuccessful financial integration may result into
financial crisis and hindered economic growth. However it is very difficult to
identify a strong and robust causal relationship between financial integration and
growth empirically. Following are the channels through which financial integration has negative impact on growth.

- Developing countries with inefficiencies in the domestic financial market and infrastructural gap cannot use external funds effectively. Therefore, capital inflows do not show a substantial impact on economic growth.

- Increased economic fluctuations in financially integrated countries generally cancel the welfare gain from increase in domestic consumption, thus having no positive impact on welfare.

- Financial integration increases the probability of financial crisis and affects economic growth negatively. A faulty sequencing of domestic financial liberalization, when accompanied by capital account liberalization, increases the chance of banking or exchange rate crises, which are often accompanied by huge output losses and negative economic growth.

- Lower income per capita in developing countries can be explained by differences in social infrastructure, i.e. governance, rule of law, respect for property rights etc. Thus not capital scarcity but lower productivity and domestic distortions are the reasons for lower per capita income. So, financial liberalization is unlikely to increase growth by itself.

According to Paul Krugman, capital is relatively unimportant and there are no large capital flows from rich to poor countries. Therefore, policies encouraging international financial integration do not stimulate economic growth. This suggests that a developing country that liberalizes international financial interactions is unlikely to boost domestic capital formation. Moreover, even if foreign funds substantially increase the domestic capital stock, this would ignite a depressingly small amount of long run growth.

The deregulation of interest rate under the financial liberalization can cause higher borrowing costs and hence, may lower economic growth in the short run. Financial liberalization may lead to various non-productive profit-seeking activities leading to severe misallocation of resources towards speculative activities. This may have adverse effects on growth.

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XVI. Social Costs

There are some significant, negative economic and social effects of financial liberalization, which are often so large that they significantly outweigh any benefits in terms of access to more capital inflows. Financial liberalization exposes a country to the following risks: a propensity to external and internal financial crises, a deflationary impact on real economic activity and reduced access to funds for small-scale producers. All these effects in turn have adverse social impact in terms of loss of employment and more volatile material conditions for citizens.

**Impact on Labour and Employment:** Financial integration has weak and mixed effects on employment. FDI inflows increase the rate of investment in recipient countries and a rising share of FDI in total investment tends to increase the demand for highly skilled labour. This shifts the pattern of labour demand in favour of high-skilled labour and increases wage inequality.

In poor and middle-income countries capital inflows cannot be used efficiently to fulfil unmet investment needs due to the large institutional gap. Thus the absence of adequate institutions makes financial integration little beneficial for growth and for labour. Financially integrated economies are trying to reduce their expenditure to achieve fiscal prudence. This reduces the social and welfare expenditure of the government; which in turn affects poor and labourers adversely. Financial globalization-led-higher consumption and output volatility too affects labours in poor countries adversely.

Generally, these social costs of financial integration are felt longer than its economic impact. During a crisis, open unemployment rises substantially, real wages fall, underemployment increases, bargaining power of a labour becomes weak and workers shift from the formal sector towards the informal economy and agriculture. Besides, crisis also exerts a downward pressure on labour share in the GDP. Thus crises are particularly harmful for labourers. Labour pays a disproportionately high cost of financial integration.

Lower rates of savings and growth under the regime of financial integration may also have a persistent, negative impact on the poor.
XVII. International Financial Concentration

Financial liberalization by many countries in the world has resulted into international financial concentration. The process of financial liberalization across the world has not generated greater net flows of capital into the developing countries, rather for the past several years, the net outflows have been in the reverse direction. The emerging markets, which are the substantial recipients of capital inflows, have not experienced increases in aggregate investment rates as they have built up their external reserves to guard against possible financial crises. Developing countries generally prefer to hold their reserves in US Treasury bills and other safe securities resulting into concentrated international financial markets. This has led to the United States economy absorbing more than two thirds of the world’s savings and developing countries losing in financial terms due to high costs of holding these reserves. Thus, in this highly concentrated global financial system, the financial institutions of the US are intermediating global capital flows and the investment decisions of a few individuals in a few institutions virtually determine the nature of the exposure of the global financial system.

Concentrated financial activity and decision-making in a few economic organizations and integrated areas of financial activity has led to growing financial consolidation. This growing financial consolidation has substantially increased systemic risk and made the international financial system more crisis-prone.

Deflationary waves and increased financial fragility across the developing world is the result of financial integration. Dominance of short term capital flows has in general increased the volatility of capital flows. Volatility of capital flows translates into exchange rate instability under flexible exchange rate or large fluctuations in official reserves under a pegged exchange rate regime and sometimes currency crises. Nominal exchange rate volatility may hamper expansion of exports if appropriate hedging techniques are not available to exporters. Large capital inflows could also lead to rapid monetary expansion (due to the difficulty and cost of pursuing aggressive sterilization policies), inflationary pressures (resulting from the effect of capital inflows on domestic spending), real exchange rate appreciation and widening of current account deficits. Contagion
effect in addition to the increasing capital account liberalization and unrestricted capital flows have become a serious impediment to global financial stability.

There are a number of adverse macroeconomic effects of internal financial liberalization too. It has been observed that there is no market determination of the interest rates even in the post-liberalization period. The central bank influences or administers that rate structure through adjustments of the bank or discount rate at which it lends to the banking system and through its own open market operations. The government influences interest rates by altering administered interest rates offered on small savings and pension/provident fund depositors. Competition among the financial institutions takes the form of non-price competition. It also leads to price competition that squeezes spreads. Under financial liberalization, banks are encouraged to accept lower spreads in the hope of neutralizing the effects on profits by attracting larger volumes of business. Easier conditions of entry do not automatically increase competition in a financially liberalized economy. Financial liberalization involves freedom to acquire financial firms for domestic and foreign players and permissions to invest in equity and debt markets for foreign institutional investors, pension funds and hedge funds. This often triggers a process of consolidation. The increasing linkages between different financial markets tend to increase the possibility of developments in any one market affecting others to a far greater degree than they did before. The universalization of banking and the proliferation of financial assets that liberalization involves have increased the risk element in the banking business. Intermediation of the short term deposits for the long term investments have also contributed to the risk element in the banking system. The liberalization process increases the degree of integration of different financial institutions within the financial system and increases the impact of financial failure in any one segment of the financial system on agents elsewhere in the system. The emergence of larger financial units and a growing role for foreign firms in the domestic financial market have led to the systemic consolidation of the financial system. This implies that the implications of failure of individual financial agents for the rest of the financial system is very large and the government is forced to intervene when wrong judgments or financial malpractice results in the threat of closure of financial firms.
Implications for the Real Economy

Financial integration-led-speculative bubbles lead to financial crises; they squeeze liquidity, induce distress sales of assets and result in deflation. This adversely affects employment and living standards. The returns to productive investment in agriculture and manufacturing generally remain limited even in course of financial integration. There is a limit to what borrowers would be willing to pay to finance such investment. In fact, social returns to agricultural and manufacturing investment are higher than that for stocks and real estate. This investment even contributes remarkably to growth and poverty alleviation. But the credit to these sectors is not available at the required rate even in the post-liberalization period.

In financially integrating countries, the stock market is primarily a place to exchange risks rather than to raise capital for investment. The new issues market is small or non-existent except in periods of a speculative boom. This tends to increase the fragility of the system. Financial liberalization led capital-inflows aggravate the consequences of the institutional change component of the process. When the possibility of financial failure threatens to become a reality, the funds dry up and capital flight occurs, which increases the intensity of the crisis. The institutional change associated with financial liberalization increases financial fragility. The relationship between financial structure, financial growth and overall economic development is indeed complex. Financial liberalization dismantles the financial structures that have been developed in the late industrializing countries and that are crucial for economic growth. By dismantling these structures, financial liberalization destroys an important instrument that historically evolved in late industrialising countries to deal with the difficulties of ensuring growth through the diversification of production structures that international inequality generates.

De-nationalization of the banking system and the penetration of the foreign banks undermine the ability of the banking sector to continue with the policies of directed credit and differential interest rates.

Financial liberalization process fundamentally alters the terrain of operation of the banks. The focus of bank activities shift away from facilitating commodity production and investment to lubricating trade, financing house construction and promoting personal consumption. The areas of operation of the banks undergo change in the course of financial liberalization with banking entities not only
creating or linking up with, say, insurance companies, but also entering into other sensitive markets like the stock and real estate markets. This increases the financial fragility of the banks.

2.5 Capital Inflows and Growth
Financial integration attracts capital inflows, which have substantial impact on growth. Flexibility of the exchange rate, sterilization, the soundness and capacity of the financial system to intermediate large volumes of capital inflows as well as the relative costs of particular policies gain importance and decide the impact of capital flows on the economy. The size, composition and quality of these capital inflows are the crucial factors which determine how financial integration gets translated into growth.

Financial stability also depends on capital flow composition because capital flows determine how risks are shared between provider and recipient. It impacts domestic fixed capital formation, affects the cyclical sensitivity of aggregate flows and influences the future pattern of international adjustments. The composition of capital flows also matters for monetary policy and for the management of liquidity, as some forms of capital flow are more sensitive to the central bank's policy rates than others.

In turn, macroeconomic policies like fiscal policies, exchange rate regime, etc. also have a major influence on the composition of capital flows. Generally an undesirable structure of foreign capital inflows often reflects poor macroeconomic policies. The sequencing of capital account liberalization measures can also influence the composition of capital flows. Fiscal indiscipline, pegged exchange rate and high interest rates, inflationary trends result into high amount of short term capital inflows, which may prove detrimental to economic stability and growth.

Following is the brief discussion about the various types of capital flows and their implications for economic growth.

I. Foreign direct investment and Foreign Institutional Investment
FDI is a form of capital inflow which is generally positively associated with domestic investment and domestic growth in a relatively consistent manner. Other forms of capital inflows also have a positive relationship, but their effects tend to
be less strong. FDI flows appear to promote economic growth in developing as well as developed countries.

Foreign direct investment flows are less vulnerable to sudden reversals and carry the potential growth benefits associated with technology transfer. Technological progress takes place through a process of capital deepening in the form of the introduction of new varieties of capital goods by Multinational Companies. Multinational corporations possess more advanced knowledge, which allows them to introduce new capital at lower cost.

The positive impact of FDI and equity liabilities on economic growth is larger for countries with (i) higher initial per capita GDP, (ii) higher level of human capital, (iii) developed domestic financial market, (iv) better institutions, (v) larger trade openness, and (vi) lower inflation rate. It implies that countries with developed financial system use external funds more effectively. Thus, increasing FDI and equity liabilities contributes to economic growth, while countries with less-developed financial systems do not use obtained funds efficiently. Countries with sound monetary policy benefit more from international financial integration. Overall, countries with good institutions and developed financial systems are more likely to benefit from increasing FDI and equity liabilities.

Thus, foreign direct investment (FDI) is a capital flow which does not increase the potential vulnerability of the capital-importing country. It represents equity rather than debt, it is long-term rather than short-term, and it is associated with increased domestic capital formation rather than increased consumption. There is evidence that equity flows, especially foreign direct investment, are beneficial because such flows disperse risk abroad and often bring in the valuable expertise of foreign firms.

The association between portfolio capital inflows and domestic investment is positive but not as strong as the relation between FDI and domestic investment. Out of total portfolio capital inflows, portfolio equity flows, are positively associated with subsequent economic growth rates. Portfolio investment into equities provides useful risk diversification and can increase the rate of domestic fixed capital formation for several years.

It has been generally held that portfolio flows, referred as hot money, are more volatile compared to other forms of capital flows. It has even been observed that
the investors pull back portfolio investments at the slightest hint of trouble in the host country, which generally leads to disastrous consequences. Portfolio flows are more volatile than direct investment flows because of their short-term nature. They are more difficult to intermediate smoothly. They can cause uneven expansion and contraction in domestic liquidity and thus have a greater impact upon stock markets and expansion in money supply and domestic credit. Sudden and large shifts in portfolio capital flows can be very destabilising. Therefore portfolio flows need to be skilfully intermediated.

Direct investment flows (FDI) are long-term in nature and less volatile. Being visibly embedded in investment in plant and equipment, FDI is less susceptible to sudden withdrawals out of the country and leads to productive uses of capital and consequent economic growth.

It is argued that financial integration attracts large amounts of foreign capital into the economy and serves the development needs of the country. However, development needs will be served only if these capital inflows add to the productive capacity of the economy. Only Foreign Direct Investment and even not whole of it but the part of it genuinely adds to the productive capacity of the economy. Foreign Direct Investment diverts production to the recipient country for meeting the global market or it produces goods essential for the recipient country but for which the country lacks the technology. But FDI which produces goods for the home market that only supplant what is being already produced does not add to the productive capacity of the economy. On the contrary it causes an implicit form of de-industrialisation. And all capital flows in the form of deposits or portfolio investments constitute short-term flows that are essentially speculative in nature which do not add directly to productive capacity.

Thus portfolio flows have a greater impact upon stock markets and domestic money supply and can lead to consumption, stock market and real estate booms via sudden expansions in liquidity in financial markets. Short-term flows therefore, need to be matched by foreign capital inflows of a longer duration and FDI flows should be encouraged to impart stability to capital inflows.

II. Debt and Equity Flows

As compared to FDI or equity flows, debt flows are less conducive to growth and if they have any positive impact on growth, it is very minimal and indirect. This is
because debt inflows are less likely to bring the benefits such as technology transfer and managerial expertise.

The debt liabilities of private financial institutions affect economic growth through increase in domestic private credit and an increase in domestic private credit tends to stimulate economic growth. In contrast, debt liabilities of public institutions have the opposite effect as such liabilities decrease economic growth through both the direct effect and the indirect effect.

III. Long Term and Short Term Capital Flows
Short term capital flows are very much volatile in nature, which may lead to uncertainty, abrupt capital outflows, and economic crises which affect growth negatively. Short maturity lending allows creditors to exit before the country is forced to restructure its debt, but long maturity loans have welfare improving effects. With short-term debt in the market, long-maturity debt also becomes risky and long-term debt can demand a large risk premium leading debtors to borrow in short maturities. Capital account liberalization may shorten the maturity of government debt. Similarly, developing country governments face difficulty issuing international debt denominated in domestic currency.

2.6 Links between Financial Integration and Poverty
The relation between financial integration and poverty is complex, multidimensional and of indirect nature. Financial integration affects poverty in both the ways- positively and negatively. Whether financial integration translates into poverty reduction, depends upon many things like- initial economic conditions of an economy, sequencing of financial liberalization, macroeconomic stability and policies, and the quality of domestic institutions, human capital and the composition of capital flows, etc.

In theory, financial integration helps poverty elimination through several channels. Greater financial integration contributes to higher growth by expanding access to capital, expanding access to new technology, stimulating domestic financial sector development, reducing the cost of capital and alleviating domestic credit constraints. Such a financial integration-led-growth reduces poverty. Similarly, access to international capital markets also allows countries to smooth out consumption shocks, reducing output or consumption volatility, which further
reduces poverty. Financial integration-led-financial deepening enhances availability of credit to poor and helps to reduce poverty. Financial integration enhances employment opportunities and helps to reduce poverty.

2.6.1 Positive Links

I. Composition of Capital Flows and Poverty
The composition of capital flows play very important role in poverty alleviation. It determines country’s vulnerability to financial crises and thereby has a significant impact on poverty. Higher the share of long term, stable capital; higher will be the favourable impact on poverty and vice versa. Foreign direct investment inflows are associated with a reduction in poverty. A rising share of FDI in total investment leads to an improvement in the average quality of employment for both high-skilled and low-skilled labour and reduces poverty. Whereas FII and other short term capital flows are likely to be relatively volatile, affecting poverty inversely.

II. Remittances
Remittances\(^{65}\) can make a significant contribution to poverty reduction, since they benefit poorer households directly. As remittance receivers often have a higher propensity to own a bank account, remittances promote access to financial services for the sender and the recipient. The stability of remittance flows despite financial crises and economic downturns make them a reliable financial resource for developing countries. These workers have the benefit of working in a high-income country and sending their remittances to a low-income country, thus benefitting financially. From a macroeconomic perspective, remittances can boost aggregate demand and thereby GDP as well as spur economic growth, having positive impact on poverty.

III. Consumption Smoothing
Financial integration-led-consumption smoothing has large welfare effects, which ultimately helps to reduce poverty. Financial integration stabilises consumption

\(^{65}\) A remittance is a transfer of money by a foreign worker to an individual in his or her home country. Remittances are recorded in current account.
by enabling access to the world credit, reduces consumption volatility and makes large impact on poverty reduction. Financial liberalization also increases the availability of financial resources to the previously disadvantaged section and helps for consumption smoothing and alleviates poverty. Financial liberalization also improves income distribution by freeing up the credit market and hence, reduces poverty. Since the poor are likely to be hurt in periods of consumption volatility, income smoothing made possible by global financial integration can be beneficial to the poor.

IV. The Productivity Channel
Financial integration improves productivity in many ways and reduces poverty. International financial integration allows inflows of Foreign Direct Investment (FDI) which brings in the advanced technology and superior management techniques and enhances the productivity of less developed economies. Increased competition by foreign players also induces domestic firms to adopt best managerial, prudential and technological practices, which in turn increase the productivity of domestic firms and labour. For example, the superior efficiency of foreign banks in allocating domestic saving has produced efficiency gains in many countries.

V. Employment Generation
Employment is a very important link which affects poverty directly. Financial integration in general and FDI in particular plays very important role in employment generation and helps to eliminate poverty. FDI flows generally enhance the demand for skilled labour, which increases the income level and productivity in an economy.

VI. Financial Development
Financial development is a crucial link between financial integration and poverty. Financial development can influence poverty positively in many ways. The financial liberalization process in general increases the availability of credit and financial services for the poor. Easing of entry under the policy of financial integration increases the number of financial institutions and a wider variety of financial products become available for the majority of the population. Increased
financial depth provides better access to credit for previously marginalized borrowers and savers. Reduction of reserve requirements also increases the supply of credit for a given level of deposits. Financial sector reforms increase real incomes leading to higher savings. Increased interest rates also increase savings and bank deposits thereby allowing banks to supply more loans, increasing total domestic and private credit. This increases the credit availability to the poor too. Financial globalization-led-greater penetration of the domestic financial system by foreign banks also has many benefits for poor. It enhances quality of financial services, provides better techniques for credit analysis and reduces risks of domestic financial instability. Increased competition among the providers of financial intermediation motivates banks to extend their services to traditionally excluded sections of the population. This opens up new financial options for savers and borrowers and ultimately translates into higher growth rates and lower poverty. Increased competition and improved distributional efficiency will also lead financial institutions to extend financial services to a larger share of the population and contribute to poverty reduction.

VII. Economic Growth

Financial integration-led-economic growth can benefit the poor directly as well as indirectly. Enhanced economic growth may favour the sectors and regions where the poor get employment, and the factors of production that the poor own. Thus poor benefit directly. Poor can also benefit indirectly through redistributive policies, especially taxes, transfers and government spendings. Financial integration enhances growth rate of an economy. And higher growth can generate greater fiscal resources to expand investments in the assets of the poor or to expand transfers and safety nets for the poor. Thus financial integration-led-economic growth can provide opportunities for redistributing the gains from growth.

VIII. Institutions and Policies

Financial globalization can bring about changes in institutional environments. As financial integration proceeds, there may emerge a new set of norms and conventions, as well as new standards of transparency, accountability and
enforcement of law, new economic and political institutions, educational facilities and accommodation of human rights. This leads to the overall increase in the efficiency and productivity of the whole system, which further benefits the poor.

IX. Globalization and global disinflation

Global disinflation has also contributed to the poverty elimination drive. In the late 90's, global inflation has dropped from 30 per cent per year to 4 per cent\(^6\). This can be attributed to improved central bank institutions and practices, improved fiscal policy, and the technological revolution and also to the increased level of competition. Interaction between increased financial globalization, deregulation, and a decreased role for governments in many economies has resulted into increased competition in the product and labour markets. This disinflation channel does have some beneficial effects on the poor in terms of lower cost of living.

2.6.2 Negative links

Financial integration provides many opportunities of growth and poverty elimination. Whether these benefits reach to the poor is the issue of concern. Whether poor are capable of participating in the growth process and enjoy the fruits of financial integration, need to be analyzed. Following are the links through which financial integration affects growth adversely. It has also been said that the poor do not benefit proportionately in the process of financial integration or even sometimes they remain excluded. This section discusses the links or the reasons why poor remain excluded or may not participate equally in the process of financial integration.

I. The Growth Channel

Financial integration may lead to lower rates of the savings and economic growth. These growth rates are lower than in the period of financial repression. Through this channel, financial globalization may have persistent negative effects on the poor. Financial liberalization even forces countries to hold a larger amount of

foreign reserves which reduces incomes and growth potential, affecting poor adversely.

Volatility may also have adverse effects on growth and through that channel, on poverty. If financial openness is accompanied by capital flight, the rate of accumulation of domestic capital decreases and may result into adverse effect on growth and on poverty.

If financial crises become more frequent, they affect growth negatively and can cancel out any benefits from financial liberalization, or even lead to a net negative effect of financial openness on growth. This can have negative impacts on labour that go over and above their general economic impact.

II. Inequalities

In the presence of high inequality, financial integration may affect growth negatively, which is one of the important links between financial integration and poverty. High inequality may limit the progress in education and accumulation of human capital. It also reduces progress in population control, affects economic efficiency, macroeconomic stability and growth. The level and nature of economic growth has strong implications for poverty elimination. A very high and rapid increase in the growth rate is very much necessary to meet the poverty elimination targets. But only economic growth does not guarantee reduction of poverty. The level of inequality is also very important because higher levels of inequality are associated with lower rates of poverty reduction at any given rate of growth. Moreover, there is a ‘U’-shaped relationship between financial integration and inequality. Financial integration increases inequalities at low income levels while at medium and high income level; it reduces inequality and promotes equality.

Financial integration-led-economic growth may increase output for a country in general, but it does not guarantee the equal distribution of gains from growth. Financial integration may cause increasing income inequality in many developing countries. Increasing inequality prevents growth from trickling down to the poor. Thus, inequality actually acts as a filter between growth and poverty. World Bank (2001) puts it rightly: For a given rate of growth, the extent of poverty reduction depends on how the distribution of income changes with growth and on initial
inequalities in income and assets and access to opportunities that allow poor people to share in growth.\(^{67}\)

Recently the globalization issues like rapid technological advancements, policy reform measures such as trade liberalization, financial liberalization and privatization, changes in labour institutions and weakening of the redistributive role of the state have all contributed to the increased global inequalities. International financial integration has also caused growing instability and rise in the frequency and severity of financial crises. Deregulated financial system may increase inequality due to the problems of incomplete information, imperfect markets and contracts, herd behaviour and weak regulatory institutions. Liberalization of the capital account increases income inequalities in the countries with weak labour institutions and social safety nets. Financial integration increases the inequalities in the countries having low level of education or no education. Financial integration creates opportunities for the people with basic and high education. Thus the income share of those with no education goes down and inequalities rise.

In Latin America and Asia, for instance, financial crises raised inequality 73 and 62 per cent of the time respectively, while Finland, Norway and Spain experienced a sequence of banking and financial crises without experiencing increased inequality thereafter.\(^{68}\)

Pro-cyclical nature of capital flows may lead to the capital flight to developed countries, particularly during periods of crisis or instability. Thus, as financial integration proceeds, inequalities tend to fall in developed countries while developing countries may experience rising inequality.

Income inequalities caused by financial liberalization are much greater than that caused by other policy changes such as trade and labour market liberalization and privatization. For example, increases in real interest rates, which is a result of the financial liberalization, benefits lenders at the expense of borrowers. A large part of the government budget in many middle-income countries goes towards interest payments rather than being used for social expenditure, as due to increased interest rate, interest payments on public debt have also increased.


Under the structural adjustment programmes accompanied with financial liberalization, increasing emphasis on greater wage flexibility, reduced regulation, reduction of minimum wages and employment protection, weakened position of workers, reduction in public sector employment and reduced government outlays in human capital formation have also affected income inequality negatively. Besides, the changes in labour market institutions such as a more informal nature of employment, decline in the wage share and growing difference between skilled and unskilled wages have contributed significantly to wage inequality and overall inequality in developing countries.

Practically, FDI inflows to developing countries are weak and do not have clear positive or negative effects on employment. Such inflows make a weak contribution to increasing the rate of investment in recipient countries. At the same time, a rising share of FDI in total investment tends to reduce the overall employment elasticity while shifting the pattern of labour demand in favour of high-skilled labour leading to rising wage inequality.

High levels of inequality can also create political instability and social problems and affect growth very negatively over the short and long term. Inequality may increase the crime rate, social tensions and conflicts. Social tensions, in turn, endanger the security of property rights, increase the threat of seizure, drive away domestic and foreign investment and increase the cost of business security and contract enforcement.

Financial integration in general leads to inequality and as inequality affects future growth and the future growth path, it also influences poverty. At any given growth rate of GDP, poverty falls less rapidly in the presence of more unequal distribution than in the case of a more equitable one. Thus, rising inequality threatens growth and poverty reduction targets.

III. The Access to Credit and Financial Services

Financial integration has increased the credit to the private sector, but mainly for established borrowers, not for poor and small scale and medium scale firms which are essential for poverty reduction. In the post-financial liberalization period, banks continue to use conventional lending methodologies like collateral security, capacity and the character of borrower, initial capital outlay and business track record, which is generally not available with the SMEs and the poor. Even after
financial sector reforms, banks naturally prefer doing business with established companies or rich people rather than providing loans to the poor due to higher processing, administrative and monitoring costs and higher risk of default and profit motive.

In developing countries, poor's access to credit or financial services remains limited due to a number of reasons. The demand for deposit facilities remains low due to lower income level, macroeconomic instability or deficiencies in the regulation and supervision of financial institutions and credit to poor gets hampered. The supply of saving facilities may not be adequate due to high fixed costs or low economies of scale associated with opening bank branches in rural areas and again poor may not get adequate access to financial services. Poor accounting practices that distort the real financial situation of borrowers or inadequate management of the financial institution itself also affect credit provided to the poor.

In developing countries, informal sector plays more crucial role in providing financial services to the poor. However, financial liberalization generally expands the formal sector at the cost of the informal sector and affects the credit and financial services availability to the poor. Shifting funds from the better informed informal to the poorly informed formal sector, will also reduce the overall efficiency of capital allocation process and worsens the resource allocation and investment quality. This in turn affects the availability of credit to the poor.

In many countries, financial sector reforms so far have not taken up the broad agenda of developing the institutional structure and new instruments to satisfy the financial needs of small enterprises and the poor. The focus has mainly been on liberalizing interest rates and encouraging entry into the formal financial institutions. These are not sufficient to improve access to credit and financial services by the poor.

Penetration of the foreign banks in domestic financial market is accompanied by a greater concentration of credit flows toward large firms and reduced access to loans by small and medium size firms, which generally tend to be more labour intensive than larger firms; this may lead to reduced levels of economic activity, lower demand for labour and possibly to a greater incidence of poverty and worsening of income distribution.
The implementation of reforms in an unstable macroeconomic environment, high and uncertain inflation rates also led to high lending rates. These excessive lending rates discouraged SMEs and the poor from borrowing. The financial integration-led- increased interest rate volatility also raises expected intermediation costs and leads domestic financial institutions to either increase domestic interest rates or to ration credit to maintain expected profits. Thus increased exposure to volatile shocks may result into higher domestic interest rates, lower domestic output and possibly higher poverty rates.

IV. Labour
All the labour market changes in the course of financial globalization like greater wage flexibility, reduced regulation, deterioration of minimum wages, reduction of employment protection, weakened position of workers, reduction in public sector employment and reduced government outlays in human capital formation, more informal nature of employment, decline in the wage share and growing difference between skilled and unskilled wages have contributed significantly to rises in wage inequality and poverty in turn.

V. Pro-cyclical Nature of Capital Flows
Pro-cyclical access to world capital markets increases macroeconomic instability and has weak effects on poverty. Favourable shocks may attract large capital inflows and encourage consumption and spending at levels that are unsustainable in the longer term, forcing countries to over-adjust to adverse shocks as a result of abrupt capital reversals. The impact on poverty may thus be magnified.

VI. Volatility
Financial integration may lead to consumption volatility, output volatility and macroeconomic volatility which are the significant threats to poverty reduction. Consumption volatility and output volatility affect poor directly. Macroeconomic volatility has indirect threats to poverty. The volatility of bank borrowing and portfolio flows may also prove costly to the poor.
VII. Financial Crisis Channel

Financial crises are generally more costly to the developing countries and the poor. In many developing countries, financial globalization has been accompanied by more frequent currency crises, which in turn have implications for poverty. These crises have a considerable impact on GDP and long-term growth prospects. Besides, labour suffers disproportionately as labour market indicators typically lack economic recovery. Furthermore, the labour share in national income is also typically eroded during a financial crisis.

Financial crises, including balance of payments and banking crises, not only affect the current living standards of the poor, but also their ability to grow out of poverty. Crises typically lead to a fall in earnings of both formal and informal-sector workers due to job losses in the formal sector and a decline in the demand for services in the informal sector. Contractionary fiscal policy that is traditionally implemented in response to a crisis leads to cuts in social programs. This may limit the access of the poor to some essential services at a time when their incomes are falling. Financial integration also affects semi-skilled and unskilled labours disproportionately, as unskilled workers are often the first to lose their jobs as firms retain their trained labour force.

Higher interest rates, which are normally associated with financial liberalization, have significant redistributational effects that affect the poor harshly, but reward the rich handsomely. As the poor normally hold a greater proportion of their wealth in cash than the non-poor, they tend to be affected more by the increased rate of inflation. Also, as nominal wages are not perfectly linked to the price index, inflation leads to a decline in real wages. This affects the poor more than the rich. Moreover, labour earnings constitute a much larger share of their total income. Poor have little or no access to public social insurance schemes because they are largely either self-employed or unpaid family workers.

Lustig (2000) shows that 'out of 20 crises in Latin America, all were followed by an increase in the poverty headcount ratio, and 15 of them by a rise in the Gini coefficient'^{69}.

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VIII. Macroeconomic policies and Institutions
Institutions and policies are very crucial in deciding whether financial globalization affects poverty positively or negatively. Institutions mediate the various channels and mechanisms through which the financial integration affects poverty. Institutions act as a filter intensifying or hindering the link between financial globalization and poverty. Lack of good educational and health institutions, lack of safety nets for the poor, average quality legal and judicial institutions, will definitely hamper the poverty elimination drive adversely.
One implication is that low income countries are more likely to benefit from financial integration if they create reliable institutions and pursue macroeconomic stabilization policies.

IX. Stabilization and adjustment programmes in developing countries
Stabilization programmes accompanied with financial globalization when implemented through conventional instruments may generate large recessions and poverty surges. Demand compressing policies to control inflation and other policies like too rapid deficit reduction, excessive fiscal prudence and the reduction of the fiscal deficit by means of pro-poor expenditure cuts may lead to recessionary trends and poverty.

X. Social Expenditure
Governments of the financially integrated countries have tremendous pressure of practising fiscal prudence, under which, countries tend to reduce social expenditure having large implications for poverty. Reduced spending on health, education and safety nets reduce the access to the health and educational facilities for the poor and reduce their efficiency, further increasing the incidence of poverty. Besides rising poverty, it also affects the ability of the poor to get out of poverty.
An increase in domestic inflation has far greater adverse consequences for the poor since the prices of tradable goods such as food and energy tend to rise fast and these constitute a substantial fraction of the consumption baskets of the poor.
2.7 Urban and Rural Poverty linkage
Financial integration mainly affects urban poverty, but rural poverty is also indirectly affected. If financial integration helps to reduce urban poverty, then rural poverty may also get reduced. For example, in the course of financial integration, more employment opportunities are created in an urban area, rural area may benefit in terms of lower incidence of poverty as labour may migrate to urban area in search of jobs. Rural area nearby the cities, face increased demand for agricultural and other tradable products, when financial integration enhances income level and standard of living of urban poor. This in turn enhances the income level and standard of living of the rural poor.

2.8 Financial Integration-Poverty relation and The Threshold Effect
The financial integration-poverty relationship is multifaceted. In the short run generally, poor cannot equip themselves with better efficiency, skills to receive the fruits of financial integration; therefore in the short run, financial integration has negative effects on poverty. But in the long run, as poor can benefit due to good education and good health facilities, their efficiency enhances, they are better equipped to participate and enjoy the fruits of financial integration-led-growth.

If an economy has good macroeconomic conditions, poor are in a better position to participate in the process of production. If a country has better economic policies in place for poor, then poor are likely to benefit more in the process of financial globalization. Thus, though a low level of financial integration tends to increase poverty, it actually reduces it at higher levels.

Thus, there is a greater possibility that globalization-poverty relationships may be nonlinear in many aspects, involving several threshold effects. Therefore, financial integration-poverty nexus should be analyzed with respect to time dimension, country conditions, domestic policies in place, the degree of financial integration etc. Then only the net impact of financial integration on poverty can be determined.
2.9 Financial Integration and Developing Countries

Theoretically, developing countries can benefit in many ways, in the course of financial integration. Financial globalization helps to raise the growth rate in developing countries through a number of direct and indirect channels. Financial integration enhances economic growth directly through augmentation of domestic savings, reduction in the cost of capital, transfer of technology from advanced to developing countries, increased investment and development of domestic financial sectors. Developing countries also benefit due to lower labour cost and lower cost of production in their countries. Financial integration also leads to increased specialization in the production owing to better risk management and improvements in both macroeconomic policies and institutions induced by the competitive pressures. Developing countries are supposed to benefit the most in the course of financial globalization, given their relatively low levels of physical capital and inherently greater volatility. Although, how much of these benefits do actually materialize in the developing world is the issue of analysis.

Liberalization of controls on inflows and outflows of capital generally result in an increase in financial fragility in developing countries making them prone to periodic financial and currency crises. One reason why financial integration does not enhance the growth in the developing countries is that the lower per capita income of these countries is due to lower factor productivity and not due to lower capital labour ratio. The financial integration and growth relation in these countries also become weak due to the existence of macroeconomic imbalances and the improper sequencing of reforms.

The indirect benefits of financial integration i.e. development of the domestic financial markets, improvements in the local institutions, better macroeconomic policies, better governance, competition and the enhanced efficiency associated with the greater competition by foreign institutions are more important in deciding the impact on growth. Developing countries generally lag behind on these indicators and cannot realise the full benefits of financial integration.

Capital inflows to the developing countries generally result into a substantial increase in foreign exchange reserves and current account surpluses. Developing countries prefer to make buffer of foreign exchange reserves to withstand possible future difficulties in external financing. This desire for a buffer is the main motive
for reserves accumulation in most developing countries. This may lead to the appreciation of a long run equilibrium exchange rate. Large inflows of foreign capital may prove difficult to the governments of the developing countries as they cannot follow independent monetary policy.

Developing countries generally have thin, illiquid and excessively volatile financial markets, due to which they cannot absorb huge capital movements. This may contribute to the vulnerabilities and magnified crises and have negative effects on the real economy.

A country’s foreign capital absorbing capacity depends upon quality of human capital, depth of domestic financial market, quality of governance and macroeconomic policies. Developing countries’ absorbing capacity of the foreign capital is relatively low due to low quality human capital, relatively underdeveloped financial markets, poor governance and macroeconomic policies. Limited capacity to absorb capital inflows cannot channel financial flows into real investment. Capital inflow volatility can lead to large and disruptive changes in real exchange rates. Capital inflows also increase the prices of existing assets and may not lead to the creation of new assets. These asset market bubbles are very much disruptive in developing countries. If developing countries build up a certain amount of absorptive capacity in order to effectively take advantage of financial globalization, financial integration may enhance growth rate.

The quality of governance, which majorly includes transparency, control of corruption, the rule of law and financial sector supervision also determine the benefits of financial integration. Lack of transparency in government operations reduces portfolio investment and corruption tends to affect the FDI flows to the developing countries. Lack of the rule of law and proper financial sector supervision also affects the ability of a country to get benefitted from financial integration.

A combination of sound macroeconomic policies, prudent debt management and exchange rate flexibility, the effective management of the capital account, the accumulation of appropriate levels of reserves as self-insurance and the development of resilient domestic financial markets will determine the optimal benefits of the financial integration. All these factors depend upon the specific country under the study and the time period.
The World Bank Development Research Group has suggested a seven-point plan to help developing countries take greater advantage of the benefits of globalization and to manage the risks associated with their integration into the world economy. The seven-point plan includes: (i) a development round of trade talks to bring down the trade barriers, (ii) improving the investment climate in developing countries to encourage inflows of FDI, (iii) improving delivery of education and health services to enable the poor to benefit from growth, (iv) providing social protection to a changing labour market to enable workers to take more risks and to avail themselves of new opportunities, (v) rich nations to increase foreign aid with impact on growth and poverty, (vi) supporting debt relief for reforms in marginalized countries, and (vii) tackling greenhouse gases which have been burdensome to poor countries and poor people.

2.10 Summary

In summary, the roots of financial integration are found in Solow's model of economic growth, Mundell-Flaming model, Kuznet's Inverted U Hypothesis and Law of One Price. Neoclassical model of growth emphasizes on the capital accumulation and says that as financial integration enhances capital base, it also boosts economic growth. Mundell-Flaming model also says that free capital flows enhances economic growth in the presence of flexible exchange rate and also warns that financially integrated country cannot have its own independent monetary policy. Law of One Price emphasizes on equal price for equal assets and stresses that developing countries have many things to benefit out of financial integration. Ultimately Kuznet's Inverted U hypothesis highlights the threshold effects in the financial integration and poverty relationship and shows that initially poverty may increase with the increase in the financial integration but after a certain level of financial integration is reached, poverty diminishes.

Theory ensures the following benefits for financially integrated countries. When countries follow financial integration, savings and investments increase. Countries experience international risk sharing and consumption smoothing. Countries are compelled to follow greater macroeconomic discipline and fiscal prudence. International financial integration could also positively affect total factor productivity.

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productivity. Financial openness may enhance the degree of development of domestic financial markets and lead to increased efficiency of the financial intermediation process. This lowers costs and excessive profits associated with monopolistic and cartelised markets. This lowers the cost of investment and improves the resource allocation. Influx of better technology generally associated with foreign direct investment and greater competition improves efficiency of domestic players. All these benefits have positive impact on growth and development of an economy.

Financial integration also has certain disadvantages. Potential costs of financial integration include lower savings and investments, the high degree of concentration of capital flows, misallocation of flows, which may hamper growth, loss of macroeconomic stability, pro-cyclical capital flows, macroeconomic, consumption and output volatility and short-term capital flows, the risk of abrupt reversals and contagion effects. This may lead to macroeconomic instability, unsustainable levels of consumption and spending, rapid monetary expansion, reserve accumulation, inflationary pressures, exchange rate appreciations and widening current account deficits. Financial integration may affect growth negatively and has significant social costs which are often very large and outweigh the benefits of financial integration.

Financial integration and poverty relationship is also very complex and multidimensional. Financial integration affects poverty in both the ways—positively and negatively. In theory, financial integration helps poverty elimination through several channels. Greater financial integration contributes to higher growth by expanding access to capital, expanding access to new technology, stimulating domestic financial sector development, reducing the cost of capital and alleviating domestic credit constraints. Such a financial integration-led-growth reduces poverty. Similarly, access to international capital markets also allows countries to smooth out consumption shocks, reducing output or consumption volatility, which further reduces poverty.

Financial integration also has some negative effects on poverty. Financial integration may affect growth negatively and thereby affect poverty adversely. Increased inequalities in the post-financial-integration period also increase poverty. Concentration of credit, volatility, fluctuations in consumptions, financial crises, reduced social expenditure also have large negative effects on poverty.
Whether financial integration translates into poverty reduction, depends upon many factors like the initial economic conditions of an economy, the sequencing of financial liberalization, the macroeconomic stability and policies and the quality of domestic institutions, human capital and the composition of capital flows, etc. Developing countries also have different effects of financial integration on growth and poverty due to the presence of different economic and social conditions of these countries.