

# Globalization of finance and the challenge of national financial sector development

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Received 10 March 2005; received in revised form 28 September 2005; accepted 30 November 2005

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## Abstract

Against the background of the significant acceleration of the pace of financial globalization, this paper examines the features of the phenomenon and the challenges they pose for national financial sector development. Although financial globalization confers notable benefits, it also entails huge costs including financial crisis. The factors of weak banking system and poor regulation helped to exacerbate the financial crises of the 1990s. The paper, therefore, stresses the need for sound macroeconomic policies, orderly liberalization of capital accounts, adequate preparation of national financial systems and meeting other pre-conditions for countries to reap the benefits of financial globalization at minimum costs.

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*JEL classification:* F02; F21; F36; G15

*Keywords:* Financial globalization; Capital account liberalization; Capital flows; Financial crisis; Financial sector development

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## 1. Introduction

Globalization is a process which integrates world economies, culture, technology and governance. It also has religious, environmental and social dimensions. Although the non-economic dimensions of globalization are no doubt important, the economic aspect is perceived to be at the heart of the (globalization) process. Economic globalization refers to the process of change towards greater economic integration through trade, financial flows, exchange of technology and information, and movement of people. On a global level, there has been an

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increase in the degree of global economic integration through trade in goods and services, as well as financial capital during the past half a century. Although developing countries as a whole have become more integrated with the world economy, the Sub-Saharan Africa (SSA) has not kept pace with the whole. In other words, Africa is the least integrated with the world economy, in terms of both trade and financial integration (Obadan, 2004a, 2004b, 2005). Africa faces the challenge of overcoming structural, policy, institutional and external obstacles to its effective and beneficial integration with the world economy.

The integration of financial markets (or financial globalization) has been a very significant aspect of the globalization process and has received significant attention in recent years through various studies (e.g., Griffith-Jones & Gothschalk, 2003; Huang & Wajid, 2002; Hausler, 2002; Prasad, Rogoff, Wei, & Kose, 2003; Schneider, 2000; Stiglitz, 2002, 2003, 2004; Wade, 2000a, etc.). International financial integration is predicated on open capital accounts of the balance of payments or capital account liberalization. Capital account liberalization entails lifting restrictions on foreign capital inflows and outflows. It is the counterpart of current account liberalization which facilitates trade globalization. The globalization of finance affects the whole economy, raising issues with regard to banking, capital markets, contractual savings, and legal regulatory structures. This is more so as the banking system and capital markets play a central role in financial globalization through intermediation of international financial flows. Considering that finance is a key dimension of globalization, and given the ease with which capital flows between countries and the impact such flows can have on national financial systems, it is imperative for national governments to take proactive measures, rather than becoming victims of reactive responses to such financial flows, by preparing the domestic financial system to withstand the possible impact. Indeed, Huang and Wajid (2002, p. 13) have noted that recent studies have increasingly pointed to the important role of weaknesses in national financial systems in triggering or exacerbating crises. It is in the light of this that this paper discusses the globalization of finance and the challenge of national financial sector development. The key point is the need for adequate preparation of national financial systems in order to reap the benefits of financial globalization at minimum costs. The rest of the paper is organized into sections as follows. Section 2, against the background of the features of globalization of finance, examines the benefits and costs. Section 3 discusses the issue of financial globalization in relation to crises and the importance of financial sector soundness, while Section 4 is a brief discussion of Nigeria's financial sector in relation to financial globalization. The final section contains concluding remarks.

## **2. Rewards and risks of financial globalization**

Globalization of finance or international financial market integration refers to the growing unification of financial markets across the world. It reflects growing links between emerging and developed financial markets. In recent decades, the pace of financial globalization has accelerated significantly and this has resulted in high capital mobility and a large volume of gross international financial flows, particularly to the developing and transition economies. In this direction, private capital flows to developing countries—mainly foreign direct investment and portfolio investment, as measured by net long term resource flows, increased dramatically in the 1990s, from US\$ 62 billion in 1991 to almost US\$ 226 billion in 2000, dropping to US\$ 160 billion in 2001 (World Bank, 2002, p. 32). Also, between 1970 and 2000, cross-border capital flows increased from less than 3% of GDP to 17% for advanced economies and from virtually nothing to about 5% for developing economies (Huang & Wajid, 2002, p. 13). Other notable

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