

THE GLOBAL FINANCIAL CRISIS AND NATIONAL FINANCIAL SYSTEMS SURVIVAL: ISSUES, DILEMMA AND SOLUTIONS

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Abstract

This paper focuses on global financial crisis and its implications on the economy of nations. The questions asked to which answers were given among others include: Is the globalization of finance profitable against the backdrop of the failure of banking institutions in the United States of America that has snowballed into a global financial crisis? If yes, do the benefits derivable from the globalization of finance actually outweigh the adverse consequences as is being witnessed now? How reasonable is the proposition for an unregulated economy in the light of market failures being seen as synonymous with the failure of capitalism? Efforts are made to propose solutions aimed at reducing the effects of global financial crisis by developing countries and Nigeria in particular with a suggestion of the need to restructure the existing international financial architecture among many others.

Keywords: Globalization of Finance, Financial Crisis, Contagion, Financial System.

Introduction

Against the background of the recent and current global financial crisis traceable to corporate irresponsibility on the part of some financial sector players in developed countries especially United States of America in the housing and credit markets, many economists and non-economists are raising their voices against the globalization of finance. In simple language, globalization of finance is evident as the integration of the financial systems of many countries of the world. On the other hand, financial crisis describes various negative changes in the financial system evident as sudden loss of value of assets, banking sector panics, credit crunch, sovereign defaults and stock market crashes among others.

Looking at the cause of the crisis more insightfully the bursting of the United States of America housing bubble and high default rate on sub-prime mortgage lending i.e. the giving of loans to individuals at interest rate below the prime lending rate with the

expectation that the properties purchased will appreciate in value and will yield returns that can ensure repayment and adjustable rate mortgages are things to point at. The rise in the interest rate payable and the fall in the price of houses made envisaged refinancing of loans difficult by borrowers. In addition, there were high risk lender practices being a fall-out of ineffective regulation of the banking sector which is almost translating to a contagion i.e. the spread of crisis from one institution to the other or one country to another from the understanding of a systemic risk.

The recent financial crisis has resulted in major losses on the part of individuals and corporate entities and nations even with reports of high profile businessmen committing suicide following the loss of huge sums of money. This paper thus seeks to look at the problem of the spread and effects of the financial crisis from the scope of one country to another especially among developing countries and on Nigeria in particular with the objective of proposing solutions to mitigate its effects.

There have been many views on the causes of the financial crisis and these include the inability of home owners to make mortgage payments, poor sense of judgement by borrowers and lenders, speculation and overbidding during borrowing period, risky mortgage products, high personal and corporate debt, complex financial innovation that concealed default risk, lack of proper government regulation. The issue now is that with the integration of financial systems and the already spill-over effects of the crisis how should national financial systems respond? Another question is whether the globalization of finance's benefits outweighs the adverse effects.

The growth of trade, deliberate removal of barriers and the advancement of technology have led to the integration of the financial systems of nations with each other. This however has both beneficial and adverse consequences depending on what factors are on display at any point in time not minding the present financial crisis in the world.

As a result of the globalization of finance, people in different countries have the opportunity of owning financial assets denominated in foreign currencies at home and abroad. Consequently, developing countries that are often characterized by low total bank deposits and sometimes unorganized stock exchanges can with the embrace of the globalization of finance expand their access to capital and develop their financial systems.

Essentially, dismantling barriers to international capital flow according to literature is thought to improve the welfare of capital deficient nations and by extension increase international trade which will ultimately lead to the growth of the economy and enhance poverty reduction. The proposition is that opening the capital account will tend to equalize rates of return leading to more investment and higher growth for developing countries.

Judging from the fact that the financial system of some developing countries does not even match up in value to the size of an average bank in some developed nations, the following characteristic features are noticeable in such countries:

- a. High financial intermediation cost
- b. Limited scope of risk diversification.
- c. Limited liquidity in capital markets
- d. Limited access to financial services and risk management products

It has been adduced that the globalization of finance can reduce these shortcomings despite the fact that it also brings new risks that need to be managed.

Globalization which is promoted by the growth of technology, migration, trade, tourism, currency convertibility and capital account liberalization makes the mobility of capital higher than it has ever been in the history of mankind. Individuals and firms who own idle funds do benefit from the globalization of finance largely through the possibility of reduced risk and improved returns synonymous with global diversification.

In clear terms, the benefits or advantages of the globalization of finance include:

- a. The ability to earn greater returns on assets by the owners of funds.
- b. The possibility of accessing funds at lower cost by the people in the receiving nations which most times are developing countries.
- c. It helps in smoothening variations in consumption as small countries are more prone to weather shocks and natural disasters etc.

Major evidences of the globalization of finance include the increased volume of offshore deposits by individuals and non-bank institutions of developing countries. In addition, portfolio flows to developing countries have grown since the 1980s although they did experience some ups and downs during the 1990s. Another indicator of financial globalization was the widespread use and growth of foreign currency deposits during the 1990s. Also the use of industrial countries currencies is on the increase in many developing countries.

However, it is instructive to say that the effects of the globalization of finance is not absolutely positive as it has been found also to have negative implications on the economy of nations especially as it concerns their financial systems. It is worth mentioning that the globalization of finance also brings about the following:

- a. Complication of the financial sector policy formulation and implementation.
- b. Volatility of the financial system operations.
- c. Loss of policy making independence.

Scholars in favour and those opposed to the present globalization of finance have based their arguments on diverse economic views. Those opposed to it have been clamoring for a return to the pre-globalized Breton Woods era which those in favour of financial system globalization believe is an economic model proposition that will not do developing countries any good. It is then reasonable to take a second look at the position of these opposing views for one to be able to take an objective stand.

Financial Globalization and Economic Development

In the light of the challenges posed by the globalization of finance contrary to the seemingly over-emphasized benefits as some have claimed, what middle point should the argument for financial globalization take? Interestingly many scholars have expressed different views on this while noting that the leap in technological advancement has promoted globalization on all fronts with its attendant benefits.

Adekanye (1990) posited that the money market has become relatively developed due to swift flow of information. Speaking in the same vein, Dahlman and Mody (1992)

posited that the growth of information technology has led to the minimization of cost of production as a result of reduced processing and delivery time, lower transaction cost, lower inventory cost and less material waste.

Sunkel et al (1995), in their report, agreed that the present world scenario is such that we have a more integrated economic transaction and by implication the promotion of international trade. The question then is whether it is all smooth stories looking back at the issue of capital account liberalization within the scope of the globalization of finance.

Kraay and Rodrik (1998), in their study, found that there is little empirical link between capital account liberalization, growth and investment rates. Eichengreen (2001), in support of the position of Kraay and Rodrik, asserts that the inability to establish a link between capital account liberalization and growth might not be unconnected with difficulty in measuring the liberalization of capital account. A related explanation is that capital account liberalization is not totally associated with increased capital inflow as it could result in increased capital outflow as well especially when the domestic policy environment is unfavorable.

Another angle to the aforementioned is that risk adjusted rates of return in many developing countries may not be attractive enough to engender sufficient capital inflow. In instances where there are inflows, the liberalization of capital account may be offset by outflows. However, proponents and supporters of the globalization of finance believe that the benefits inherent in the smoothening of variations in consumption distortions in small economies are significant.

This proposition was supported by Bosone, Honoban and Long (2002) who posited that small countries often have higher export demand variability. Hence the volatility of small countries commodity terms of trade and their private consumption as well as the unenviable Gross Domestic Product gives some basis for supporting the globalization of finance.

According to Reynolds (1965), foreigners holding equity and risk-sharing assets often absorb part of national volatility. Also local residents holding foreign assets provide diversification against their own country expressing a supply decline or a fall in export prices. Capital liberalization also increases the volatility of Gross Domestic Product (GDP) as inflows of capital can without notice turn into outflows as it did in Russia and East Asia which resulted in exchange rate crisis.

In addition, foreign inventory assets and liabilities provide investors with some protection against inflation, instability and repression of interest rates. On the part of government though, this is often a dangerous bait because if it is not properly contracted, lower cost of a foreign currency loan often translates in the immediate to lower budget deficit as a percentage of GDP. However if the currency of the borrowing country is devalued while the loan is on, it becomes a serious problem.

Looking at foreign assets from the net addition to the economy, the relative better access of domestic banks to foreign investors' capital helps in building a strong financial system where lower production costs and lower cost of risk absorption is the case. This is consistent with the understanding of benefits related to economies of scale. The arrival of

foreign banks in other countries also often stirs up healthy competition that puts domestic banks on their toes. Foreign banks being more efficient than local ones help stimulate better service delivery.

Despite the aforementioned benefits, there are still inherent risks in the globalization of finance. For example in the event of the devaluation of a country's domestic currency, foreign currency liabilities or debts may cause a borrower to go bankrupt. The way to go round this risk is for financial institutions to hedge foreign exchange risk by matching their foreign exchange deposits with foreign currency loans.

Another issue is that citizens employed in local financial institutions may lose their jobs as a result of the competition induced by the globalization of finance. This position was supported by the argument that foreign banks that are new entrants often price their products especially loans below that of domestic operators in order to attract and gain business. They are often willing to accept smaller margins than the domestic competitors and over time may push domestic operators out of the market. There is also the assumed impression that foreign banks are more stable than local ones and the tendency is for depositors to move funds to the foreign banks in what has been termed a flight to quality as experienced during the Asian crisis and the Tequila crisis in Argentina.

In another sense it is not likely that small borrowers will benefit from the influx of foreign banks. What is not known is whether foreign owners of funds will be willing to make funds available to small users especially in the informal sector where the greater population of businessmen in developing countries fall. Berger et al (2000) in their study found that small businesses are more unlikely to get credit from foreign banks than the larger ones.

The Global Financial Crisis, the Nigerian Financial System and the Economy

There is no gainsaying that the global financial crisis is affecting different nations of the world including Nigeria though in different magnitudes. Worse hit are the different national financial systems that are in themselves the transmission mechanism of the crisis to other sectors of the economy by virtue of their intermediation roles. This is in agreement with Alan Greenspan (1997) assertion that the interdependence between markets and market participants within and across national boundaries will be transmitted far more rapidly through out the world economy. Earlier pointers to the fact that a crisis in one part of the world will reverberate strongly to others was seen in the turmoil in the European exchange rate mechanism in 1992, the plunge in the exchange value of the Mexican peso at the end of 1994 and early 1995 resulting in the sharp exchange rate adjustments in Asian economies.

In an attempt to downplay the effects of the crisis on the Nigerian economy and so as not to cause any panic in the nation, the managers of the Nigerian economy gave the impression that the country was insulated from the crisis. Nothing could be more untrue even in the light of the crash in the prices of stocks in the capital market, the fall in the revenue accruing to the country from crude oil, reduction in lending to the real sector as has been witnessed lately.

Also against the background of the similarities that have been drawn between the margin lending to finance the purchase of stocks in the Nigerian Stock Exchange by people who do not have sufficient income to service the loans with the weird United States and United Kingdom mortgage lending it is evident that the Nigerian economy cannot be totally insulated from the effects of the crisis. It is equally instructive to note that many Nigerian banks are involved in joint financing of projects with foreign banks and any crisis rocking such partners will also affect the Nigerian bank in question. Moreover some of our banks have offshore credit lines that have already been withdrawn as a result of the effect of the crisis in those foreign nations where the funds originated.

Another angle to it is that Nigeria uses a lot of foreign donor partner funds to finance development projects and it is obvious that the quantum or value of such funds will fall in response to the global credit crunch. In summary effect of the crisis on Nigeria as is being witnessed now include:

- a. The collapse of commodity prices
- b. Revenue contraction
- c. Stock market crashes
- d. Declining capital inflow
- e. Decrease in foreign reserves and pressure on the exchange rate
- f. Reduced foreign trade finances for banks
- g. Foreign partner divestment from the capital market.

It is gladdening however to know that in the wake of the global financial crisis, proactive measures were taken by the government to mitigate its impact, such measures include:

- a. A review of the cash reserve from 4% to 2%.
- b. Reduction of liquidity ratio from 40% to 30%
- c. Reduction in the monetary policy rate from 10.25% to 9.75% and which have gone further down
- d. Rescheduling of existing bank facilities granted for the purpose of buying shares into long tenure
- e. The suspension of the recapitalization of capital market operations
- f. The suspension of the common accounting year-end policy for banks.

The aforementioned measures are good but they have not sufficiently positioned the banking industry well. For example the industry liquidity decreased from 52.95% in September 2008 to 49.22% in October 2008 and as at now has fallen beyond the October figure. On the part of the capital market operations, there has been a significant decline of all indices of measuring capital market performance.

STATISTICAL SUMMARY OF MARKET PERFORMANCE IN 2008

ITEM	2008	2007	% CHANGE
Market Capitalization	N9.56 trillion	N13.295 trillion	(28.1)
The NSE All-Share Index	31,450.78	57,990.22	(45.8)
Total Turnover Volume	193.14bn shares	138.1bn shares	39.85
Total Turnover Value	N2.4 trillion	N2.1 trillion	14.3
Average Daily Volume	775.65 million units	570.6 million units	35.94
Average Daily Turnover	N9.55 billion	N8.62 billion	10.8
New Issues Approved	N2.2 trillion	N2.4 trillion	(8.3)
Number of listed Companies	213	212	0.5
Number of listed Securities	301	309	(2.6)
Number of trading days	249	242	2.9

Source: SEC Quarterly, March 2009

The insurance industry has not fared any better, if anything at all, it has been worse hit as there has been a continuous decline in premium earnings since global financial crisis started taking its toll on the financial system.

National Financial Systems Survival: Nigeria in Focus

Against the backdrop of the threats national financial systems are prone to and specifically Nigeria, what survival strategies should be put in place to prevent the adverse effects of the globalization of finance and also to maximize the benefits of financial globalization knowing too well that there is no way the globalization trend can be stopped. Then since no nation can successfully isolate itself from the already existing and on-going globalization of finance, the risk associated with capital account liberalization can be reduced by putting in place strong and workable financial regulations and supervision. The crisis witnessed in East Asia in the 1990s and the one being witnessed in America has been linked to the weakness of financial regulations and supervision which Nigeria must learn from so as not to make a similar mistake even now that banks capital base has been increased reasonably.

Also the appropriate capitalization of different operators in the financial system i.e. insurance firms, capital market operators, banks, and other non-bank financial institutions must be pursued as necessary so that we can have a strong financial system that can withstand periodic shocks. Though the Nigerian financial system is not yet strongly integrated into the global financial system and this has saved us from the strong impact of the present crisis in a way due to the fact that the use of credit cards is still at its lowest ebb, it is obvious that in no distant future, the use of credit cards will become increasingly popular. One other thing that has saved Nigeria to some extent in this period of global financial crisis is the conservative approach of Nigerian banks to lending which has helped in reducing the size of non-performing loans from 25% in 2001 to about 8.5% in 2007 according to the Central Bank of Nigeria.

It must equally be borne on mind that the stability of the financial system is dependent on a sound public policy backed by adequate disclosure of timely and accurate economic and financial data. This will be of benefit to investors while policy makers also will be enabled to assess the extent of potential emerging threats to the financial system. As well, there is the need for the enhancement of financial institutions' internal risk management system and extra vigilance. This becomes imperative as the financial system operations increase in size because envisaged risks could mean that any procedural or policy misalignment could result into the financial system being severely punished.

Conclusion

In the light of all the issues discussed above, there are people canvassing for the national approach to finance evident as the adoption of national currencies and previous preferences of nations to rely largely on internal or domestic funds to drive their economies as a way to forestall the negative effects of the globalization of finance. It is instructive to say that this protectionist approach to national financial system management will not be beneficial to the economy in question in the long-run.

Though contrary to the view of some early supporters of the globalization of finance like Alan Greenspan who in 1997 expressed the view that the existence of environment of inflationary expectations being built into both business planning and financial contracts will ultimately give way to an environment of lower inflation in future have not materialized, what ought to be done by nations of the world is adjustments of public and economic policies to counter the effects of evident or emerging crisis.

Recommendations

It is therefore recommended that for funds from other countries to benefit Nigeria as well as other national economies, the following to be ensured:

- a. Effective regulation and supervision of active players in the financial system to avoid fraud.
- b. Ensure good information flow especially to users of funds.
- c. Transparency, market integrity and deliberate check on corruption.
- d. Prudent investment by banks and pension funds.
- e. Proper legal frameworks to check and punish the abuse of procedures.
- f. Developed infrastructure to support the financial system such as power and effective communication system.
- g. The economy has to be diversified to be less import dependent.
- h. The capital base of banks may have to be increased further.
- g. Only reputable foreign financial institutions should be allowed entry into the domestic economy.

On the whole, if developing countries including Nigeria are to benefit maximally from the globalization of finance, there is the need for a restructuring of international financial architecture of world financial institutions and their personnel structure.

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