FINANCIAL INNOVATION AND A GLOBALIZED FINANCIAL WORLD

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Abstract

In the last 25 years, financial systems around the world have gone undergone unprecedented changes. Investors can borrow large amounts of money at cheaper rates than ever before, invest in a very large variety of sophisticated financial instruments, seeking the profits and sharing the risk with strangers from across the globe, at speed of light. Because of the globalization of financial markets throughout the world, entities in any country seeking to raise funds need not be limited to their domestic financial market. Nor are investors in a country limited to the financial assets issued in their domestic market. Globalization means the integration of financial markets throughout the world into an international financial market. Have these undoubted benefits come at a cost?

Keywords: financial innovation, financial market, globalization, financial crises

JEL Classification: G01, G15, E44

Financial flows increased globaly over the last decades. Wanting to channel funds from lenders tp borrowers banks and financial institutions have expanded their activities, gaing new markets, other then the national one.

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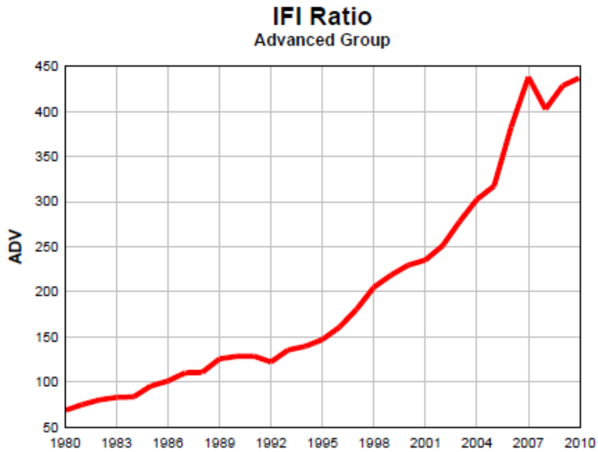

Figure 1. Taken from P.R.Lane, „Financial globalisation and the crisis", 2012[1]

As showen by figure 1 and 2, the sum of foreign assets and liabilities (IFI ratio expresses their ratio over GDP) had grow from almost 75% to 450% for developed countries and from 35% to 75% for emerging countries, prooving that globalisation realy exists.

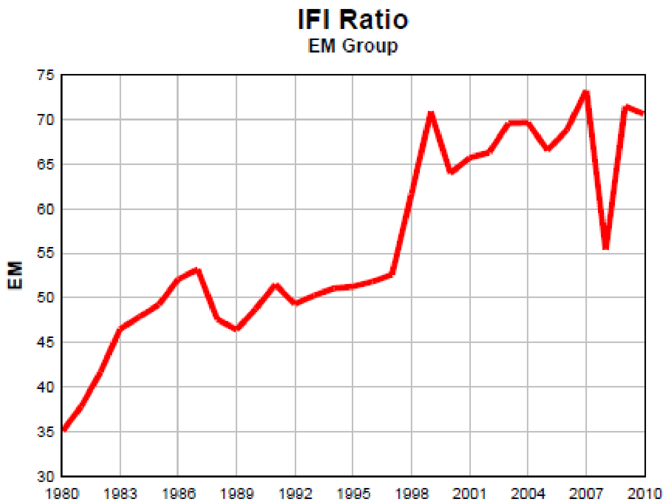

Figure 2. Taken from P.R.Lane, „Financial globalisation and the crisis", 2012[2]

[1] P.R.Lane, „Financial globalisation and the crisis", 2012, https://www.google.ro/url?sa=t&rct=j&q=&esrc=s&source=web&cd=3&ved=0CCsQFjAC&url=http%3A%2F%2Fsiteresources.worldbank.org%2FINTABCDESK2009%2FResources%2FPhilip-Lane.pdf&ei=ISVOVbjyJMHoUISJgegP&usg=AFQjCNE7ZhGLphMiurz_8zOnNRMYCHzZbA

[2] Idem1

The process of globalisation was well suported by technological advances and financial innovation. In fact we can speak about four factors that boost the process of financial globalization[3]:

- *Advances in information and computer technologies;* it's easier for today investors to stay in touch with foreign markets and their characteristics due to the proliferation of the IT industrie;
- *The globalization of national economies;* companies tend to became more and more globelized as they try to benefit from scale economy or from competitive advantages;
- *The liberalization of national financial and capital markets*, this came as a response investors' demand of new markets were they can send their surpluss funds in order to mitigate risks or to gain more;
- *Competition among the providers of intermediary services*, investors can acces differnet markets due to the development in the IT industrie so they crate a fierce competition between intermediary services' providers.

Due to globalization large events that ocurre in an economy may influence others, through direct or indirect chanels. The proofe is the recent financial crisis that trigger a large economic crisis. There are some economists that are blameing financial inovations that were introduced by banks and financial institutions in order to reduce their risk and to atract more investors. We can argue that not financial innovations „per se", but not understending them was might be a cause. In fact innovations „good or bad" are the main mechanism behind the developing of every economic activity.

"Innovation is the central issue in economic prosperity" [4] or „Innovations enhance the efficiency with which needs are met and that is why the innovation process will never cease"[5] .

Financial innovation is old phenomenon. Modern banking first started in 14th-century Florence and insurance practice can be traced to Lloyd's Coffee House in 17th-century London. Reinsurance is one of the oldest innovations in the insurance sector.

The most important future of the present financial system are innovations. So analyzing this financial innovation is paramount. The recent global financial crisis has highlighted risks brought by financial innovation while forgeting about its benefits for an economy, but innovation has helped individuals and

[3] www.imf.org

[4] Michael Porter

[5] Mugur Isarescu

businesses to attain efficiency by presenting new possibilities for mutually advantageous exchanges of goods and servicesc

Innovation means "*creation (a new device or process) resulting from study and experimentation*". So financial innovation would mean "*creation of a new security resulting froms study and experimentation*".

Financial innovation is "the act of creating and then popularizing new financial instruments, technologies, institutions, markets, processes and business models – including the new application of existing ideas in a different market context".[6]

In fact "by increasing the variety of products available and facilitating intermediation, financial innovation can promote savings and channel these resources to the most productive uses. It may widen the availability of credit, help refinance obligations and allow for better allocation of risk, matching the supply of risk instruments to the demand of investors willing to bear it. In addition, innovation may encourage technological progress when the requirements for information technology generate new technological projects, and induce their funding as in the case of venture capital."[7]

There are studies that show how a better developed financial market may help a country economy firstly by reducing the cost of capital and then by growing the productivity.

We can say that the financial system is defined as "the collection of markets, institutions, instruments and regulations through which financial securities are traded, interest rates are determined and financial services are produced and delivered around the world"[8].

As financial system is part of global economic system, it is the one influence the price and quantity of available funds in the economy. It's the creator of the flow of funds between various economic entities: companies, financial and governments' institutions, households.

Some authors classify financial system functions as[9]:

1 – monetary function (connected with money creation process and the process of money transfer between economic entities);

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[6] World Economic Forum, A World Economic Forum report in collaboration with Oliver Wyman, „*Rethinking Financial Innovation, Reducing Negative Outcomes While Retaining The Benefits*", 2012

[7] M.Sanzhez, „*Financial innvovation and the global crises*", International Journal of Business and Management, vol.5, no.11, november, 2010

[8] J.Blach, " *Financial innovations and their role in the modern financial system – identification and systematization of the problem*", published in Efinanse, 2011, vol. 7, nr 3

[9] J.Blach, " *Financial innovations and their role in the modern financial system – identification and systematization of the problem*", published in Efinanse, 2011, vol. 7, nr 3

2 – capital allocation function (enables the transfer of surplus funds);
3 – controlling function (monitoring the flow of funds in the economy).

There are different reasons for financial innovation, like:

- Hedging against different types of market' risks (development of interest rate swap and of credit default swaps)
- Mathematical innovations (development of option market, development of Collateralized Debt Obligation, flash trading)
- Tax and regulation avoidance (development of checking account, total return swaps).

J.Schumpeter distinguish between the following groups of innovations[10]:
- new products
- new methods of production
- opening new markets
- new sources of supply of raw materials
- new organization forms and busbiness structures
- new methods of management.

There are different criteria for innovation clasification[11]:

- ***sources of innovations***: *supply-driven innovations* (financial institutions being the ones that determin the apperence of financial innovations in their quest to of catching the eye of investors ; considering a growing market that will consume this new financial instruments) and *demand-driven innovations(*or 'consumer voice',what investor wants, needs and their preferences for a special type of financial investment) . Choosing wich of the two will have a more positive role over the financial market its not a simple thing because as Henry Ford famously said, "If I had asked people what they wanted, they would have said faster horses."
- ***factors of innovations***: *external factors driven innovations* (factor determined by global economy prospects) and *internal factors driven innovations* (requiered by the development of the financial system)
- ***motives of innovations***: *adaptive innovations* (new financial products that seek to get respond to new trends), *aggressive innovations, defensive innovations* (innovations induced in sectors adversely affected by

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[11] J.Blach, " ***Financial innovations and their role in the modern financial system – identification and systematization of the problem***", published in Efinanse, 2011, vol. 7, nr 3

openness that might offset part of the comparative advantage), *protective innovations* and *responsive innovations*

- ***elements of the financial system***: *financial market innovations, financial institutions innovations, financial instruments innovations* and *financial regulations innovations*
- ***types of innovations***: *product innovations, process innovations, risk-shifting innovations*
- ***underlying assets***: *debt-linked innovations* and *equity-linked innovations*

Almost all economist think that financial innovation's "effects are uncertain, unmeasurable and depend upon the interactions of innovators, users, consumers, competitors, etc."[12]

As the recent economic crises proved there are some innovations that were not understood by investors like:

- securitization - process allows global investment to be spread out to reduce risk. This made easier for individuals to purches homes, so the houses' prices rise and so did the default on this loans. In 2009, an estimated $8.7 trillion of assets globally were funded by securitization.[13];
- credit default swaps – parties involved agreed that in a third party will not pay the loan they will pay it insted (used by AIG) . The lack of transparency made this innovation turn in a bad one, because the parties did not know the extent of the risk they were taking on;
- colaterized debt obligations - mortgages, instead of being held by banks and mortgage companies, were sold to investors that took the risk;
- hedge funds – initially this investment funds were created to reduce different types of risks, but they evolved into „gainig instruments" that brought a rising of the accompaining risk;
- subprime loans – loans available for individuals that usually who faill to respond to credit demands. Setting-up this kind of credits rise the risks of credit institutions.

Unsuspected risks of financial innovations led national supervisors and regulators to take defense reactions, imposing new regulations to prevent the occurace of financial crisis. In our opinion the firts rule will be to make this

[12] World Economic Forum, A World Economic Forum report in collaboration with Oliver Wyman, „***Rethinking Financial Innovation, Reducing Negative Outcomes While Retaining The Benefits***", 2012

[13] "Too Big to Swallow," Economist, 16 May 2009, 11

products more transparent and make them available only to trained public, if not only to financial institutions..

Contemporary financial markets are in continuous transformation, and their diversification and grow is determined on one hand by the existence of increasingly tough competition in the financial market, and on the other hand by regulations,: there are new financial instruments, new market segments and new financial institutions, most appropriate new context, or that respond better to the needs of investors and financial intermediaries. The financial market is continuously dynamic, always new; however, new financial products bring with them new risks and new challenges for supervisors. But we should take into account that the innovation process can be so dynamic and sophisticated that those that regulate or supervise the markets can not keep the pace.

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5. "Too Big to Swallow," Economist, 16 May 2009, 11

6. www.imf.org