

# “Paradoxes of Financial Globalization”

## AUTHORS

Serhiy Kozmenko  <https://orcid.org/0000-0001-7710-4842>  
 <https://www.webofscience.com/wos/author/record/Z-3430-2019>  
Helen Chuyko

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## Paradoxes of Financial Globalization

Sergey Kozmenko\*, Helen Chuyko\*\*

**Abstract.** The article studies the process of financial globalization. The major objective is to study the main paradoxes of financial globalization – the phenomenon of “home bias” and the paradox of "*Feldstein-Horioka*". Assessment of the paradoxes of financial globalisation is especially important during depression periods, which are taking place in the world economy, because their analysis makes it possible to evaluate the stage of development of the globalisation process as well as its ability to develop even under the conditions of economic depression. The study results in stating that international financial crises of the 1990s did not affect the international investors' confidence in the perspectives of financial globalization. It is proved by the growing mobility of international investment capital and also by the investors' wish to diversify the portfolio of securities by purchasing securities issued in different countries. Apparently, under such conditions financial crises can be considered an additional powerful stimulus for financial globalization rather than a barrier for its development.

**Key words:** financial globalization, international investors, securities, mobility of capital, financial crisis.

### Origins and Essence of the Term “Globalization”

The term “globalization” was introduced by T. Levit in 1983. According to T. Levit globalization is the merger of markets of certain goods manufactured by transnational corporations. The scholars of the Harvard Business School gave a more substantial definition of the term. The leader of the research team in the field of international financial markets K. Ohmae in his book “World without borders” published in 1990 emphasized that the state of world economy depends on the triad consisting of the European Union, the United States and Japan. In his view, the development of economic nationalism has no sense at all.

Today globalization means formation of global transnational corporations, intensification of world trade, financial globalization, etc.

The basis of globalization is the activity of transnational corporations. Financial globalization is the result of transnational corporations' international investments. The United Nations' study on trade and development published in 1997 notes that “direct foreign investments continue to be a moving force in the process of globalization. A big growth in direct foreign investments testifies to the important role that transnational companies play in the developed and developing countries”.

At first, financial markets served the real sector of economy: they helped to ensure corporations against exchange risk, financed short-term transactions, etc. But gradually financial markets began to play an independent role. They grew in number. Their capabilities regarding the maximization of profitability and minimization of risk on the world financial markets increased considerably.

Today it is possible to make a conclusion that it is not the real sector of economy that shapes the financial sphere on the international market, but financial markets determining the level of countries' development.

Indeed, with only 10 % of daily currency transactions being in foreign trade, the exchange rate is influenced not so much by fundamental economic factors, but by the current situation on the financial markets.

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\* Doctor of Sciences in Economics, Chair of Department of Management & Foreign Economic Relations, Ukrainian Academy of Banking of National Bank of Ukraine, Sumy, Ukraine.

\*\* Senior lecturer, Chair of Management & Foreign Economic Relations, Ukrainian Academy of Banking of National Bank of Ukraine, Sumy, Ukraine.

This situation would be impossible if countries' authorities did not support financial globalization on macroeconomic level. The movement towards the united market requires constant stimulation, i.e. elimination of barriers for international investments and international financial transactions. In other words, this movement requires liberalization of national economies.

### Paradoxes of Globalization

Some economists are prone to doubt the existence of financial globalization. This view has some reasons behind it. The process of creation of common market has certain peculiarities. The most difficult of them are the phenomenon of "home bias", paradoxes of *Feldstein-Horioka* and some observations showing that the level of pure international capital flows is not very high. In the world economic literature these economic paradoxes which contradict the conception of financial globalization are known as "globalization puzzles". Let us look at some of these "puzzles".

### The phenomenon of home bias

This phenomenon is widely debated in scientific circles. While considering that diversified investment portfolio results in possibilities obtaining higher profits at a fixed investment risk compared with non-diversified portfolio, the international financial portfolio should become more diversified.

Table 1

The distribution of shares of national and foreign corporations in portfolios of American, Japanese and British investors

Country of issue	Share of stock in portfolios of international investors, %					
	American		Japanese		British	
	1991	1999	1991	1999	1991	1999
USA	93,80	95,00	1,31	6,18	5,90	8,14
Japan	3,10	2,02	98,11	92,94	4,80	3,10
United Kingdom	1,10	1,02	0,19	0,24	82,00	82,4
France	0,50	0,44	0,13	0,18	3,20	2,82
Germany	0,50	0,32	0,13	0,15	3,50	2,60
Canada	1,00	1,20	0,12	0,31	0,60	0,94

The existing portfolios of international investors are characterized by considerable shift towards national assets if compared to the optimal investment portfolio built with the help of the Capital Assets Evaluation Model of W. Sharpe.

Having compared the results of the study of K. French and J. Poterba for the year 1991 with the similar results received by researchers of the Ukrainian Academy of Banking for the year 1999, the conclusion can be made that the phenomenon of "home bias" is still taking place in the beginning of the XXI century. One should mention that though it has become less important for Japanese investors, it is still important for British investors, and it has become more important for American ones.

This can be explained from the economic point of view. The rates of the efficiency growth of American capital market by far outpace the rates of the efficiency growth of other world's financial markets. This makes American financial market very attractive both for domestic and international investors. Moreover, high diversification of the US economy attracts more and more portfolio investors from Europe and Japan, which do not enjoy such high growth rates of their own

economies' branch diversification. This means that the pace of globalization is dictated by the US financial market.

At first sight the deterioration of the crisis in the US economy in the beginning of 2001 should have had a profound influence on international investors' investment decisions. But according to the data given in Table 2, the role of the "home bias" phenomenon did not increase.

Table 2

The distribution of shares of national and foreign corporations in portfolios of American, Japanese and British investors

Country of issue	Share of stock in portfolios of international investors, %		
	American	Japanese	British
USA	94,05	6,85	9,40
Japan	2,38	91,32	3,52
United Kingdom	1,11	0,79	76,34
France	0,40	0,24	3,90
Germany	0,44	0,19	3,95
Canada	1,62	0,61	2,89

Taking into consideration the data of Table 2, one can make a conclusion that international investors continue to increase the share of international assets in their securities portfolios. Special attention should be paid to British investors. In 2001 their portfolios contained only 76,34 % of securities issued in the United Kingdom. In 1991 this figure was 82 %. This shows that financial crises of the 90s helped to reduce the role of the "home bias" phenomenon since international investors started to pay more attention to the regional diversification of securities portfolio.

### **Feldstein-Horioka paradox**

The Feldstein-Horioka paradox deals with the behavior of international investors that classical theory cannot explain. If financial markets were fully united, all savings would also be pooled. Theoretically one can assume that residue savings should be transferred to the countries where financial markets give the highest investment profit and where there are no correlations between domestic savings and domestic investments. But in reality there exists close correlation between domestic savings and investments. This shows that no process of integration of world's financial markets is going on there. In other words, the researchers of the Feldstein-Horioka paradox have come to the conclusion that rather than trying to export the redundant capital, markets absorb the surplus of investments on the domestic market.

### **Interpretation of the Paradoxes of Globalization**

There is much evidence that shows that integration of world financial markets has no future. If we try to interpret the puzzle of globalization in a different way, the future of the process of globalization will not look so dim as it did before.

Many researchers believe that the effect of portfolio risks diversification is limited for the following reasons:

- there are goods that have no circulation on the market. Securities that have no circulation on the market can be of great value for national investors as they yield high profits in comparison with international financial instruments;
- the distribution of risks is very sensitive to the peculiarities of theoretical models. The evaluation of potential advantages of international diversification of portfolio risks depends on the specific elements of a particular model such as market's size, structure,

technological level of the country's economy, behavior of economic agents, etc. That is why it is practically impossible to make general conclusions because of the specific features of every model;

- according to investment qualities foreign assets should not necessarily surpass national assets for the hedging of expenses from uncertainties with wages and salaries. The periods of recession are inevitably accompanied by the falling of corporate profits while wages and salaries change at insignificant rates and with some lagging. As a result, part of the expenses of corporations on wages and salaries begins to grow. In this process the correlation between expenses on human capital and financial assets becomes weak - this compensates the attractiveness of foreign assets used for the hedging of uncertainty with wages and salaries.

It should also be mentioned that apart from the drawbacks of the theory of international diversification of investment risks there are additional expenses and risks for international financial transactions.

The "home bias" phenomenon can be caused by the norms of state regulations, investment costs, low information efficiency and conservatism of managers. International investment requires huge investments into human capital. If this investment is launched, the following expenses are considerably reduced, which makes future investment easier. This reduction of expenses can be called "the reduction of premium for the risks in making innovative decisions".

If such situation exists on the market, it is accompanied by increase of reinvestment opportunities for corporations as a result of reduction in dividend cash payments. In 1999 researchers of Harvard University developed the theory according to which 100 % of corporations' reinvestments of net profits make it possible for them to use 100% of their own resources for the market growth. On the microeconomic level this increases the efficiency of both financial markets and countries' financial systems.

National borders can really be a barrier on the way to international capital movement, as the real advantages of international investment are not as big as they are supposed to be. At the same time, risks and expenditures of international investment are so high that they nullify all attempts of international investors to use the international diversification of portfolio risks. These expenditures and risks include exchange market, market low information efficiency, risk of time difference, conservatism of managers, state financial conservatism.

## **The Concept of Tax Elasticity as a Measure of Taxation System Efficiency in Ukraine**

Iryna Lukyanenko\*

**Abstract.** Rather than allocating resources and setting quarters for output, the state in transition countries now provides certain public services, such as national defense, law enforcement, environmental protection, and social security nets for vulnerable sections of population. The success of such government activity significantly depends on the budget revenues collected from taxation.

In assessing the efficiency of a tax system in terms of collecting revenue for the budget and determining the scope for necessary reforms the concept of tax elasticity is useful. It is often of interest to have a measure of how "responsive" tax revenue is to some changes in tax rate or any other taxation requirements. One of such measures is elasticity that can give a picture of built-in flexibility of taxation system in terms of raising budget revenue. Therefore, our analysis applies the concept of elasticity of a particular tax with respect to GDP and the tax base. This can allow to

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\* Candidate of Sciences in Economics, Head of Chair of Finance of National University of "Kiev-Mohyla Academy", phone number: (044)239-24-94; e\_mail: luk@eerc.kiev.ua.