The Drivers of Financial Globalization

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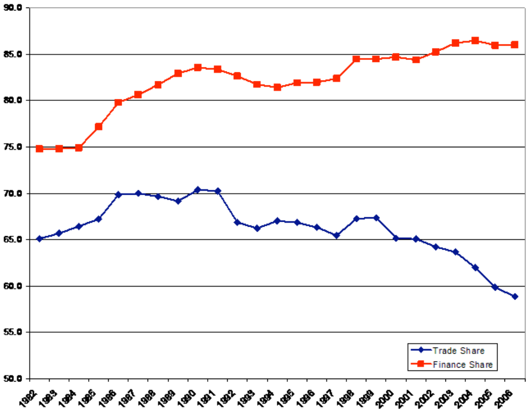
Introduction

- Emerging markets a growing fraction of world GDP and world trade
- Growth in FX reserves
- Sovereign Wealth Funds
- Key element in global imbalances configuration

Share of Advanced Economies in World Trade and World Cross-Border Financial Positions



Note: Authors'calculations based on EWN and WDI data.

Table: Global Shares of Advanced Economies

Global Totals	1996	2006	External Categories	1996	2006
Trade	67.4	58.4	Debt assets	84.0	88.6
Stockmarket Capitalization	87.9	83.3	Debt liabilities	80.3	90.3
Debt Securities Outstanding	93.8	90.9	Portfolio equity assets	92.6	90.8
Bank Deposits	87.2	79.1	Portfolio equity liabilities	90.1	86.2
Foreign Assets	84.2	85.6	FDI assets	90.2	89.1
Foreign Liabilities	81.1	86.5	FDI liabilities	72.3	73.8
			Reserves	48.3	28.3

Note: Authors' calculations based on EWN, WDI, World Bank and Global Financial Data sources.

The Differential Nature of Financial Globalization

- Tremendous Heterogeneity in international financial linkages
- Extensive cross-border asset trade among advanced economies
- Financial Innovation (Securitization, Hedge Funds, SPVs, ...): (a) often targeted at cross-border arbitrage; (b) innovation in country A creates demand from investors in country B
- The Euro (Intra-EMU asset trade but also extra-EMU asset trade)

Financial Globalization and Developing Countries

- Lower degree of participation in wave of financial innovation
- Currency risk still a limiting factor
- Improvement in net external position
- Shift towards equity financing of liabilities (FDI, portfolio equity)
- Growth in gross foreign assets (but reserves largest component)

Features of the Global Distribution

- Advanced economies net borrower from developing countries
- Advanced economies 'long equity, short debt'; opposite pattern holds for many developing countries
- Trade and financial integration at different stages
- Implications for international transmission of shocks
- What explains cross-country variation in financial globalization?

Cross-Country Variation in Financial Globalization

- Focus on three central factors: Trade Openness, Domestic Financial Development, Capital Account Restrictions
- Complementarities between Trade Openness and Domestic Financial Development
- We estimate the reduced-form equation

$$F_{it} = \alpha + \beta * TRADE_{it} + \gamma * FINDEV_{it} + \rho * TRADE_{it} * FINDEV_{it} + \sigma CAPOPEN_{it} + \varepsilon_{it}$$

where F_{it} is the level of foreign assets or liabilities, $TRADE_{it}$ is the trade-GDP ratio, $FINDEV_{it}$ is a measure of domestic financial development and $CAPOPEN_{it}$ is the de jure index of capital account openness developed by Menzie Chinn and Hiro Ito (2007).

Table: Cross-Sectional Variation in Foreign Asset and Liability Positions, 2006.

	(1) ALL FA	(2) ALL FL	(3) ADV FA	(4) ADV FL	(5) DEV FA	(6) DEV FL
TRADE	0.55 [0.31]*	0.58 [0.28]**	0.55 [3.1]	0.40 [3.1]	0.21 [0.13]	0.28 [0.13]**
FINDEV	0.88 [0.18]***	0.82 [0.16]***	0.55 [0.95]	0.33 [0.96]	-0.33 [0.12]***	-0.15 [0.12]
TRADE* FINDEV	0.001 [0.001]	0.001 [0.001]	0.009 [0.015]	0.008 [0.015]	0.005 [0.001]***	0.003 [0.001]***
CAPCON	16.40 [7.81]**	16.35 [7.1]**	19.38 [52.6]	-41.81 [53.1]	2.23 [3.5]	5.68 [3.35]*
Constant	-67.3 [32.0]**	-21.3 [29.1]	-61.1 [239.2]	163.3 [241.4]	28.4 [14.9]*	55.1 [14.3]***
Observations	69	69	21	21	48	48
R^2	0.77	0.68	0.72	0.63	0.96	0.92

Note: OLS estimates. Standard errors in parentheses. ***, **, * denote significance at 1, 5 and 10 percent levels respectively. FA and FL are ratios of foreign assets and foreign liabilities to GDP; TRADE is ratio of exports plus imports to GDP (WDI database); FINDEV is ratio of sum of stockmarket capitalization and bank deposits to GDP (World Bank and other sources); CAPOPEN is Chinn-Ito index of de jure capital account openness.

Future Trends in Financial Globalization

- Pace of trade integration
- Deepening of domestic financial systems
- Convergence in scale and characteristics of international financial integration between advanced and developing economies
- Decline in relative importance of reserves (and SWFs)

Risk Factors

- Convergence process could be interrupted by crises, especially in developing countries
- Self-fulfilling pessimism (Martin-Rey, AER, 2006)
- Small, less liquid financial systems and shifts in global portfolios (e.g. current surge in capital flows to developing countries)
- One response: financial repression and financial insularity
- Trade-off between stability and long-term growth?

Conclusions

- Variable geometry of trade integration and financial integration
- For advanced economies, financial innovation and monetary integration key drivers of growth in cross-border holdings
- Asymmetries between advanced and developing groups
- Convergence conditional on domestic financial development in the latter group