

International Capital Markets: Topics

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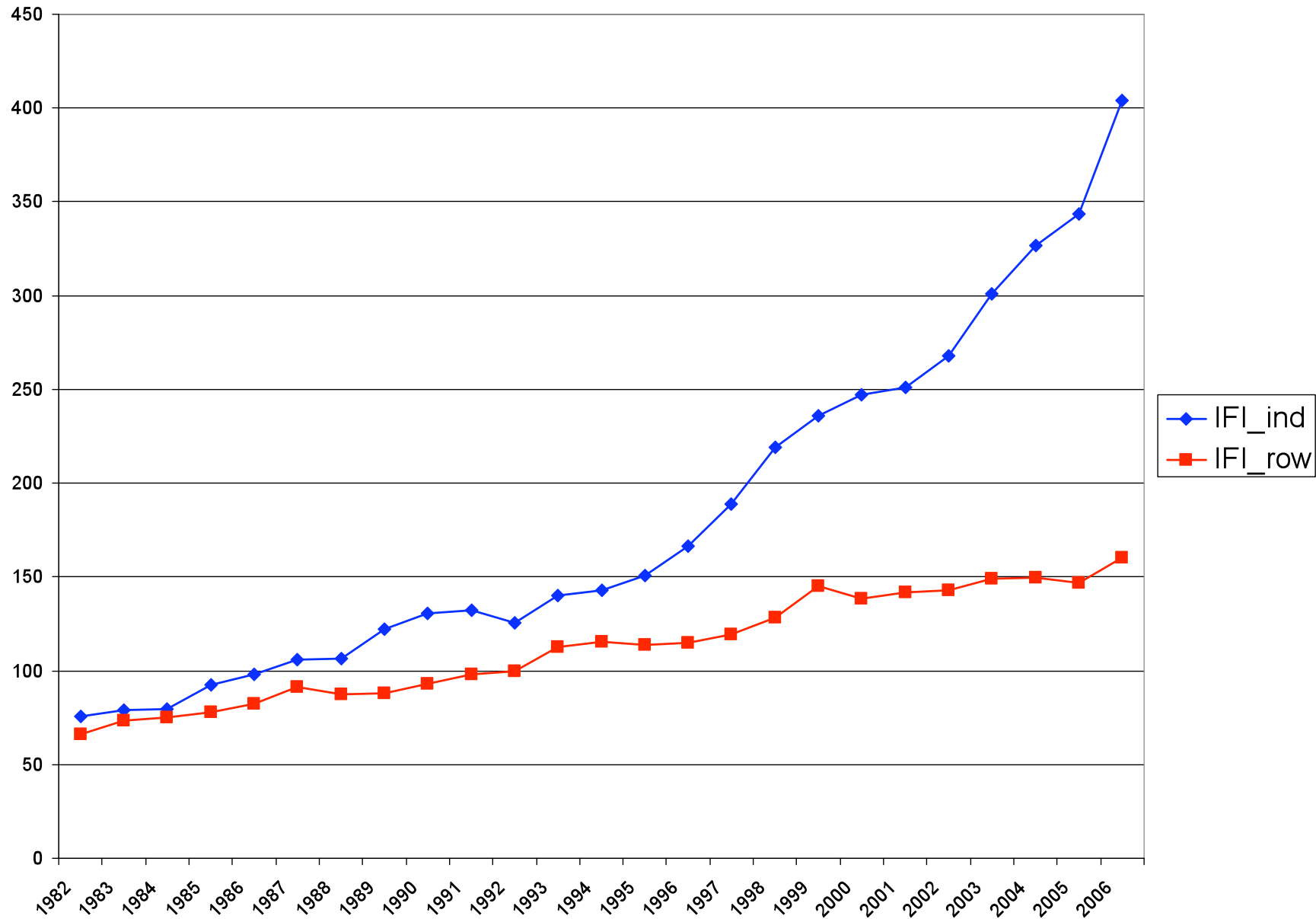
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Overview

- Spectacular increase in cross-border financial positions during 1995-2007
- (But financial de-globalisation in 2008-2009)
- Drivers of Financial Globalisation
 - Net flows (consumption smoothing, efficient investment)
 - Gross flows (risk sharing)
 - Additional factors
 - ✧ Competition in provision of financial services
 - ✧ Tax minimisation
 - ✧ Regulatory arbitrage

International Financial Integration, 1982-2006



The Drivers of Financial Globalization

- Trade Openness
- Financial Development
- GDP per capita
- Country Size
- Capital Account Openness
- Euro / European integration process
- International Financial Centers

The Differential Nature of Financial Globalisation

- 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 Globalisation 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)

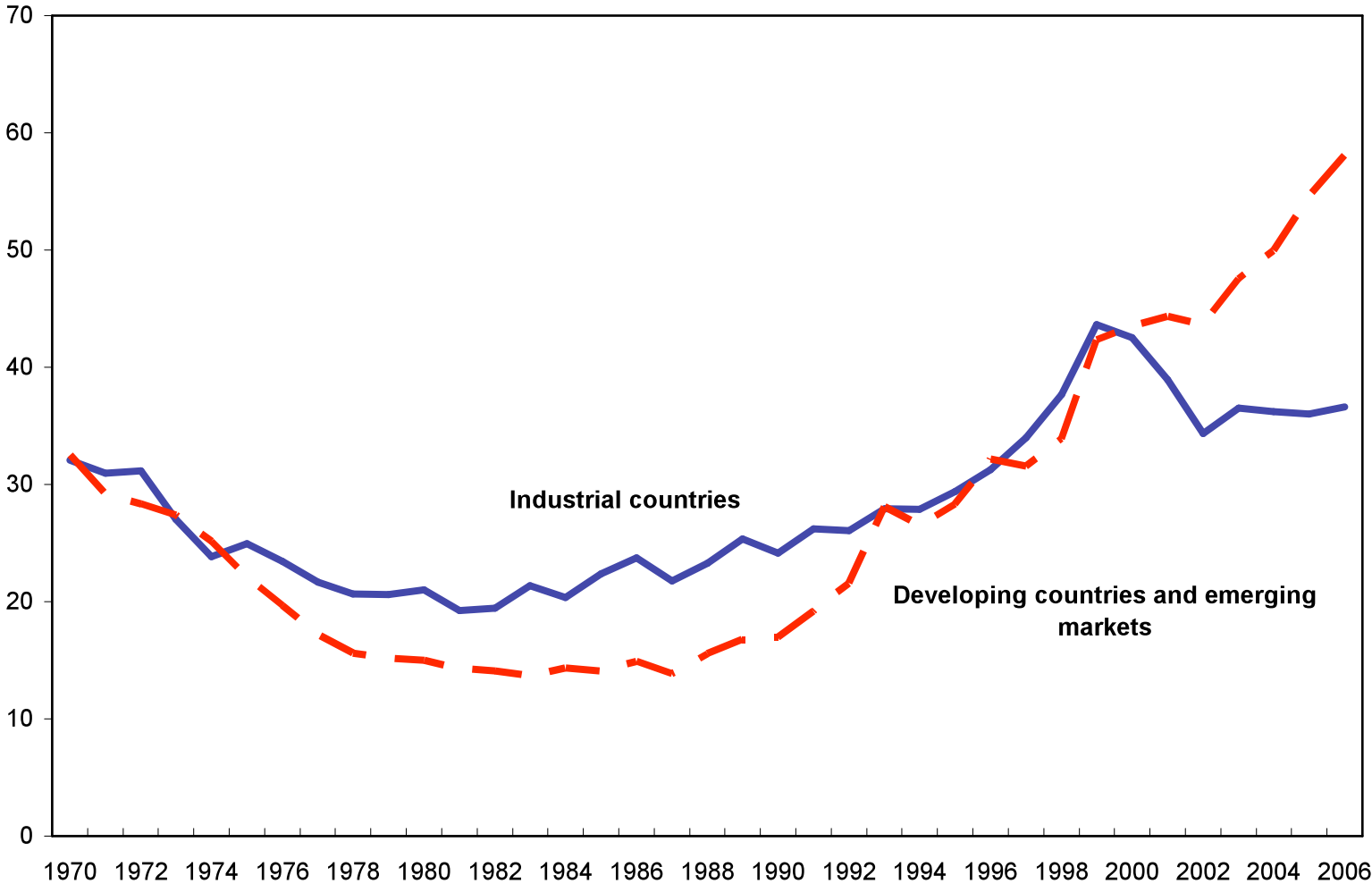
Why Are Developing Countries Vulnerable?

- Negative Pull Factors
 - Historical reputation
 - Trend volatility in fundamentals
 - Fiscal procyclicality
 - Fragility in external funding mechanism: foreign-currency debt
- Negative Push Factors
 - Output sensitivity to growth slowdowns in advanced economies
 - Correlations in risk premia across markets
 - International Finance multiplier: redemption calls; margin calls; funding of positions

Foreign-Currency Debt

- Limited liquidity in local-currency debt markets
- “Original Sin” (!)
- Missing markets externality
- Discipline effect versus risk sharing

Equity Share in External Liabilities: Industrial Country Group and Emerging Markets and Developing Country Group, 1970-2006



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 stage

Future Trends in Financial Globalisation

- Depends on 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)
- Reversal of capital flows: China as world's largest debtor economy?

Long-Run Impact of Financial Globalisation

- Key is contribution of financial globalisation to productivity
- [Gain to capital deepening fairly limited unless productivity is improved]
- Any increase in probability of crises may be dominated by long-term gains

Impact on Productivity

- Domestic financial development: strong connection between financial development and long-term economic growth
- Reallocation of resources to most productive sectors and firms
- Greater risk tolerance under financial integration: promotes selection of higher-risk, higher-return projects

Firm-Level Evidence

- Reduction in firm-specific investment risk spurs innovation and investment:
- Foreign acquisitions of domestic firms spurs technological transfer and improved governance
- Acquisitions in advanced countries by EM firms a useful way to improve technology
- Entrepreneurial activity stimulated by FINGLOB

Thresholds and Ancillary Mechanisms

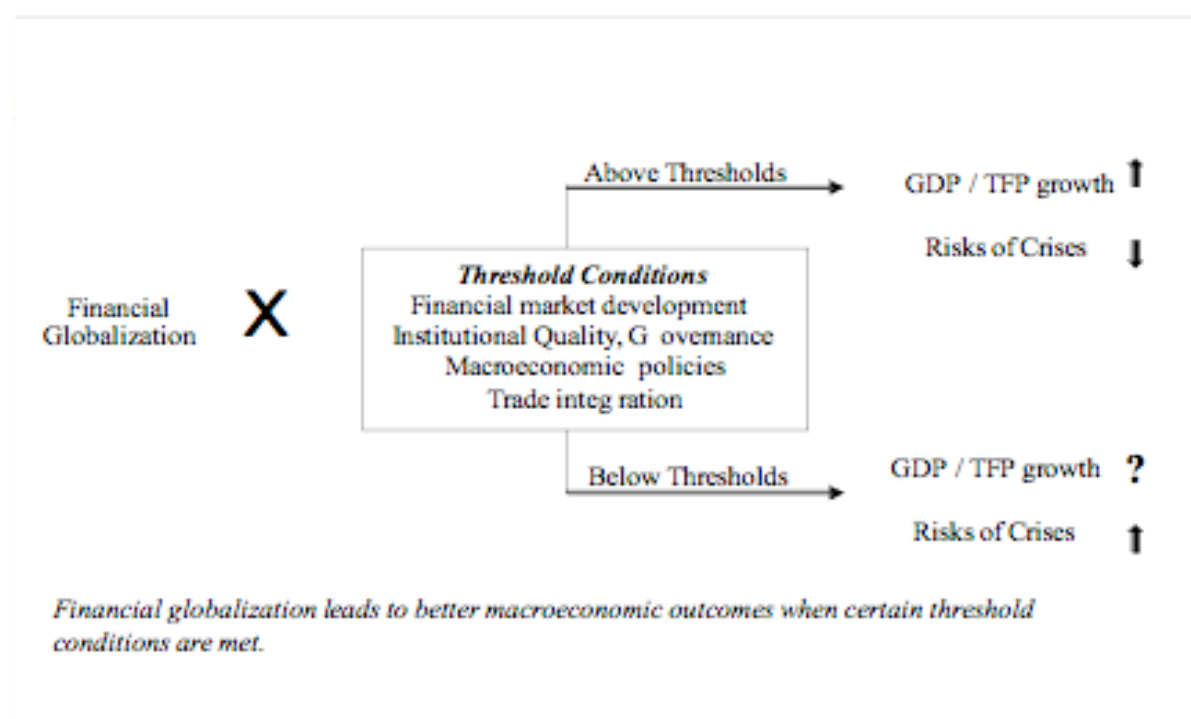
Gains from FINGLOB conditional on several domestic factors:

- Domestic financial development
- Institutional quality
- Macroeconomic policy discipline
- Trade Openness

Dynamic Interaction:

- These factors also influenced by ancillary effects of FINGLOB
- Political economy of domestic reform (veto power of incumbents weakened)
- Gains to good policy choices amplified
- ‘Agency of external restraint’

Figure 1. Thresholds in the Process of Financial Integration



Source: Kose, Prasad, Rogoff and Wei (2009)

Policy Dilemma

- Excessive speed in liberalisation may lead to increased distortions: magnification effect
- But overly-slow path constrains productivity growth

Obstfeld, “International Finance and Growth in Developing Countries: What Have We Learned?,” IMFSP, 2009

- Strong revealed preference for financial openness (FO)
- FO promotes domestic financial development
- Gains to FO increasing in domestic levels of financial development, institutional quality and macroeconomic stability
- Feedback between FO and these domestic indicators
- Gradualist path appropriate
- Trade openness makes financial autarky less feasible

Final Remarks

- Appropriate response to current crisis is to improve operation of international financial system, rather than retreat from globalisation
- Crisis Avoidance and Management: Expanded role for IMF
- Incrementalist approach by developing countries, with tight focus on domestic institutional/policy environment
- Ongoing development of research on implications of financial globalisation for external adjustment dynamics