

The Macroeconomic Implications of Financial Globalization

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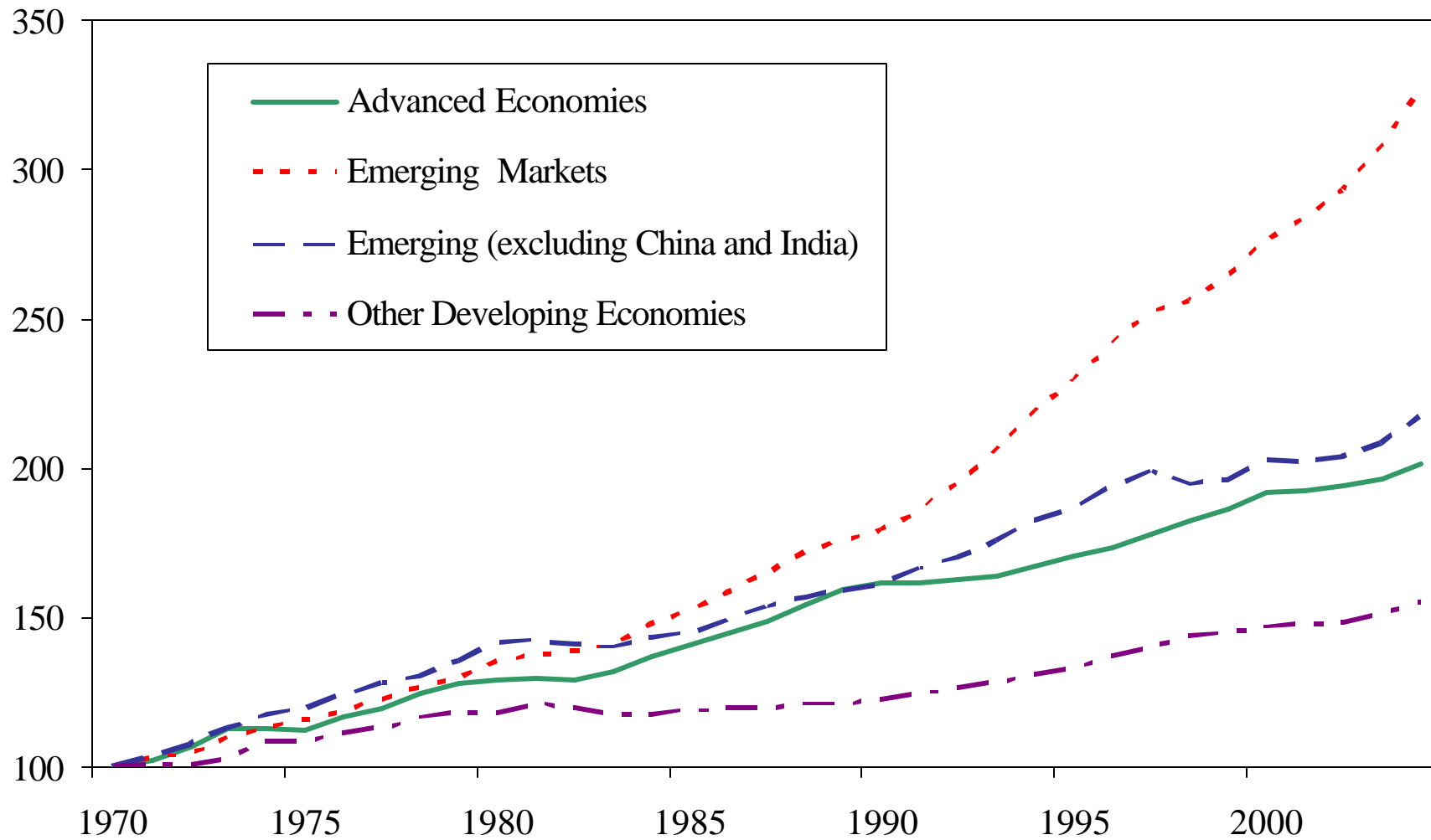
Kenneth Rogoff (Harvard)

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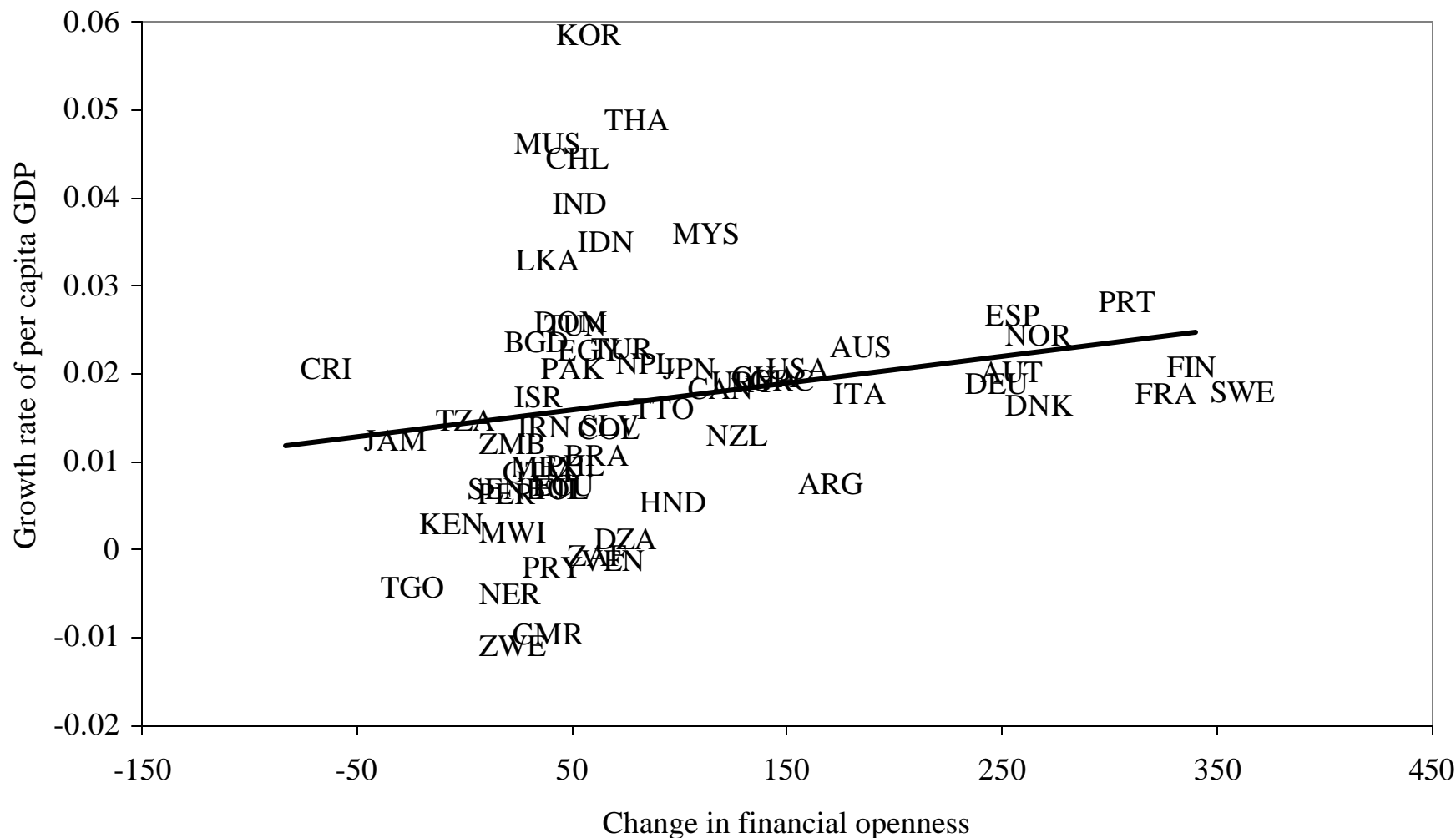
Benefits of Financial Integration: Theory

- Efficient international allocation of capital
- Consumption smoothing via international risk sharing
- Large welfare effects for developing economies

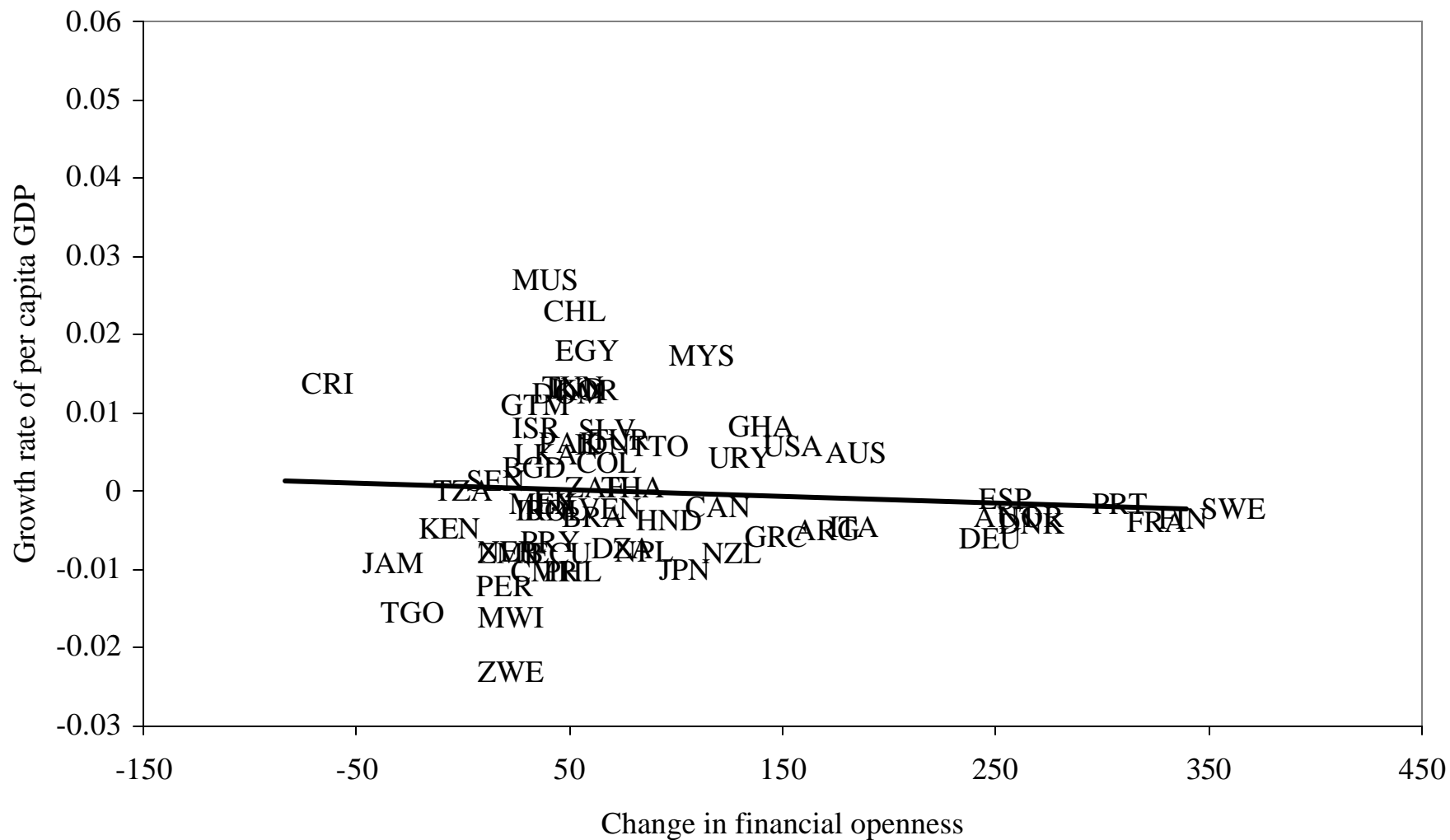
Figure 4. GDP (per capita, PPP weighted): 1970-2004



**Figure 5B. Change in Financial Openness and GDP Growth, 1985-2004
Unconditional Relationship**



**Figure 5B. Change in Financial Openness and GDP Growth, 1985-2004
Conditional Relationship**



Growth Benefits of Financial Integration: Evidence

About 25 studies of growth effects

No effect:	4
Mixed:	18
Positive:	3

Growth: Why Such Diverse Results?

- Finer measures of integration, de jure or de facto, tend to yield more positive results
- Sample of countries: Effects much weaker in poor developing countries
- Time span of sample: Longer datasets yield more positive results

No robust macroeconomic evidence of growth benefits

Financial Integration and Volatility: Evidence

- Capital mobility does not increase probability of sudden stops or current account reversals (Edwards)
- Banking crises are most disruptive and occur frequently in closed economies

No evidence that financial integration by itself is proximate determinant of financial crises

But Two Issues on Volatility

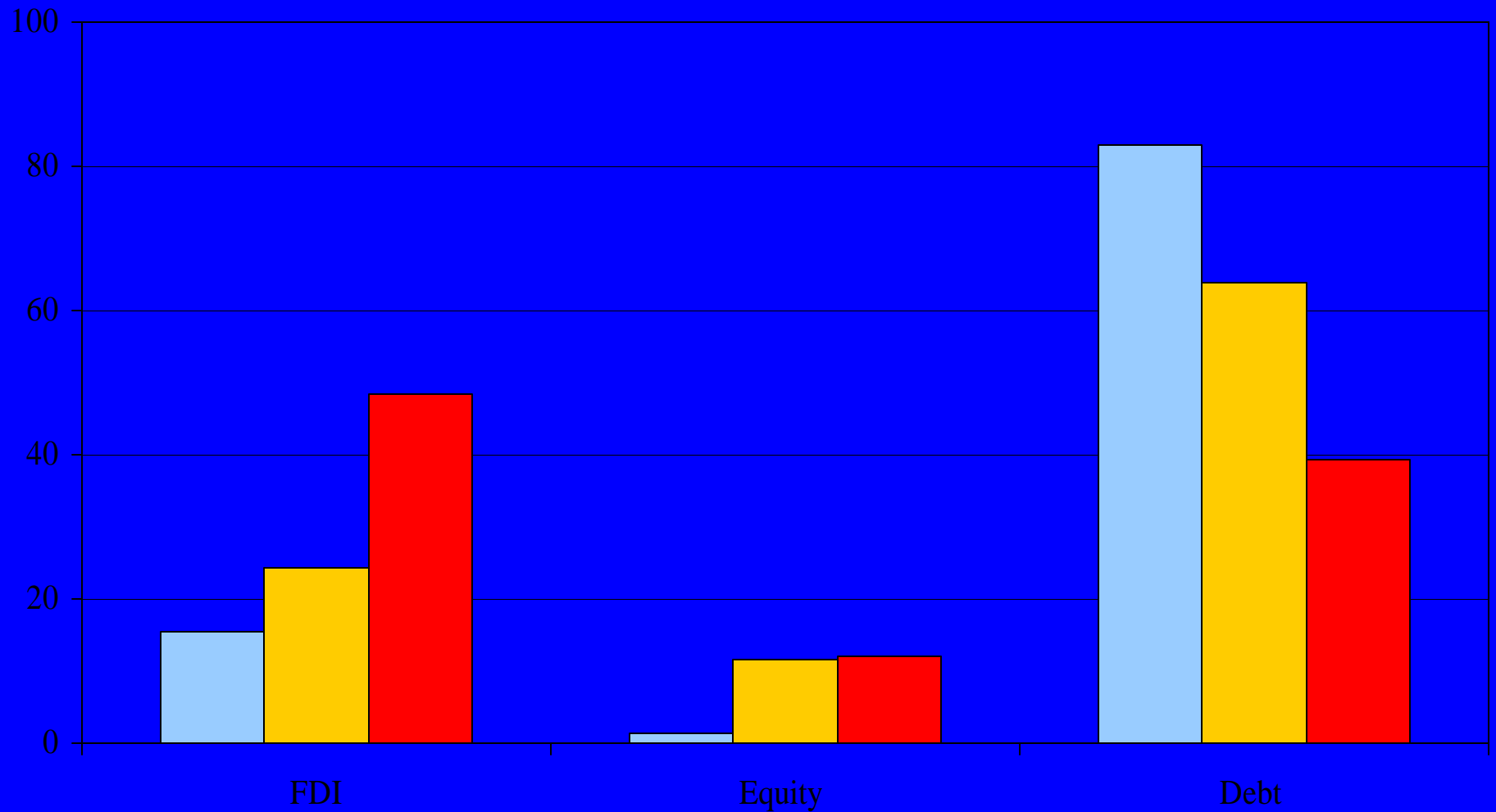
- Relative volatility of consumption growth increases at low and intermediate levels of integration
- Developing economies, including emerging markets, have not attained better risk sharing

Other Ways of Looking at the Data

- Effects of different types of private capital flows:
 - > Equity flows
 - > FDI
 - > Debt
- Macroeconomic vs. microeconomic evidence

International Financial Integration: Distribution of Gross Inflows (% of Total) Emerging Markets

80-84 90-94 00-04



Equity Market Liberalizations Boost Growth

Big positive growth effects (Bekaert, Harvey, Lundblad)

Lower cost of capital, private investment booms, productivity growth (Henry)

Allocative efficiency (Chari and Henry)

Equity Market Liberalizations Boost Growth: Really?

- Portfolio equity flows relatively small
- De jure measures—not actual flows—used in these studies
- Equity market liberalizations coincident with other reforms

Foreign Direct Investment

- Should in principle be the best
 - > stable
 - > transfers of technology, expertise
 - > right sorts of incentives
- But difficult to detect growth effects
 - > macroeconomic evidence mixed
 - > microeconomic evidence also weak
- Evidence of vertical spillovers

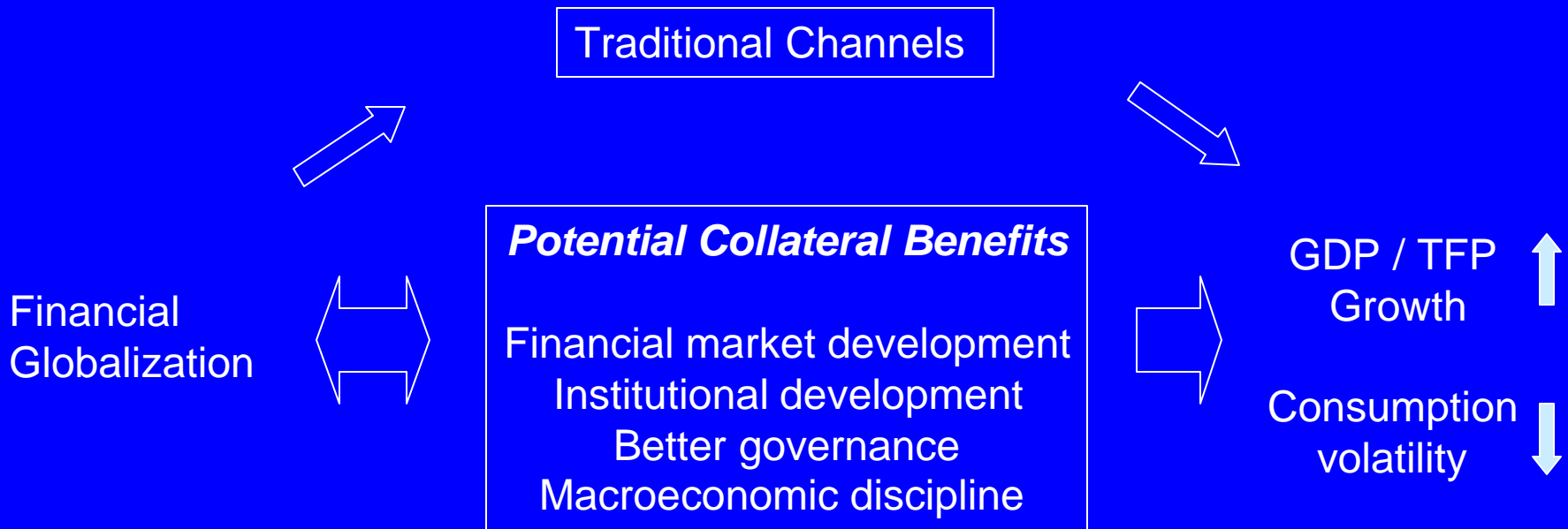
Summary of New Evidence

- Equity market liberalization seems to work
- FDI benefits becoming more apparent
- Benefits more evident in micro data

The Traditional View



A Different Perspective



FG and Financial Development

- Foreign ownership of banks improves efficiency of domestic banking system
- Inflows add to depth of equity markets
- Financial sector FDI has benefits

Figure 6A. Financial Openness and Financial Development: 1985-2004
Private Credit/ GDP

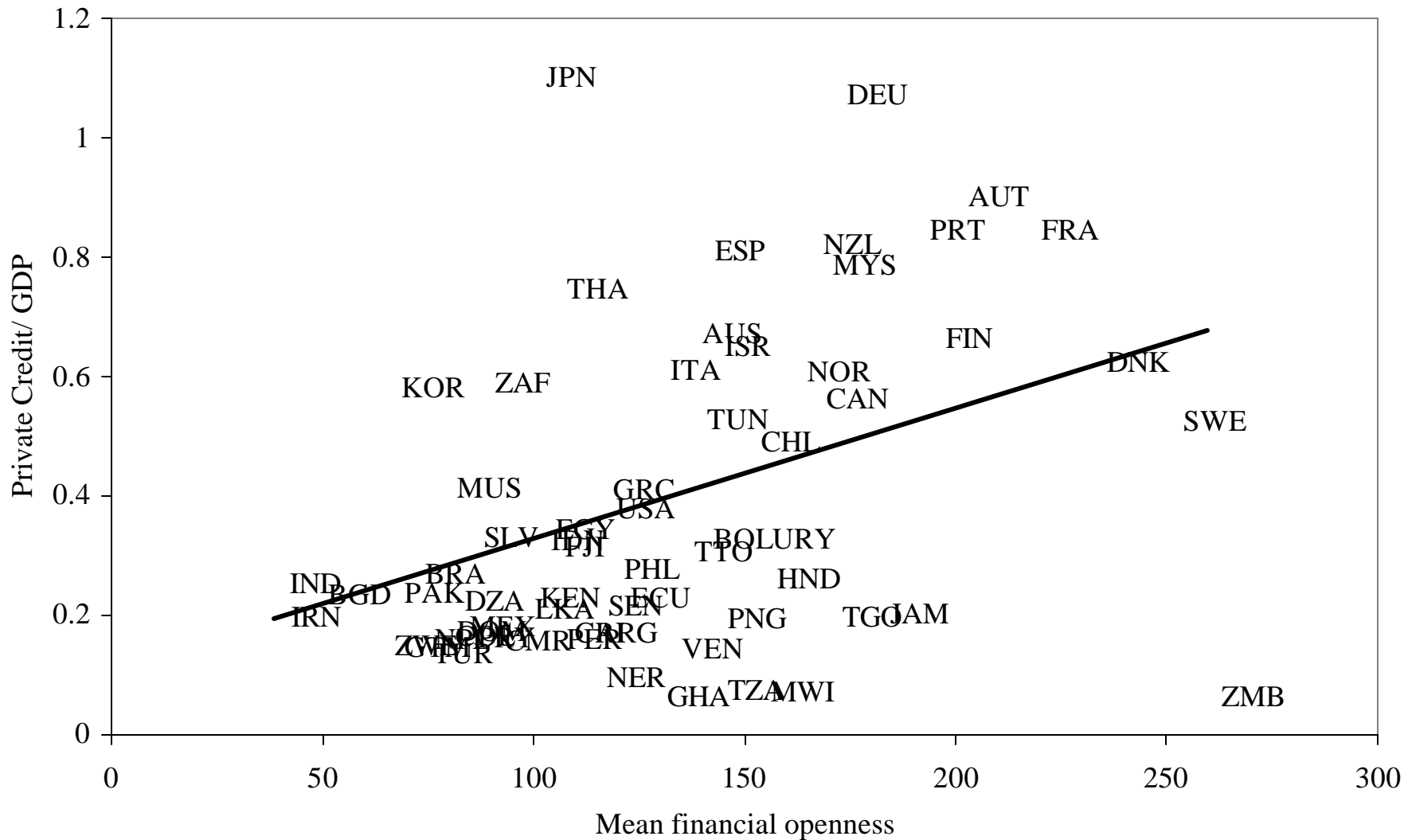
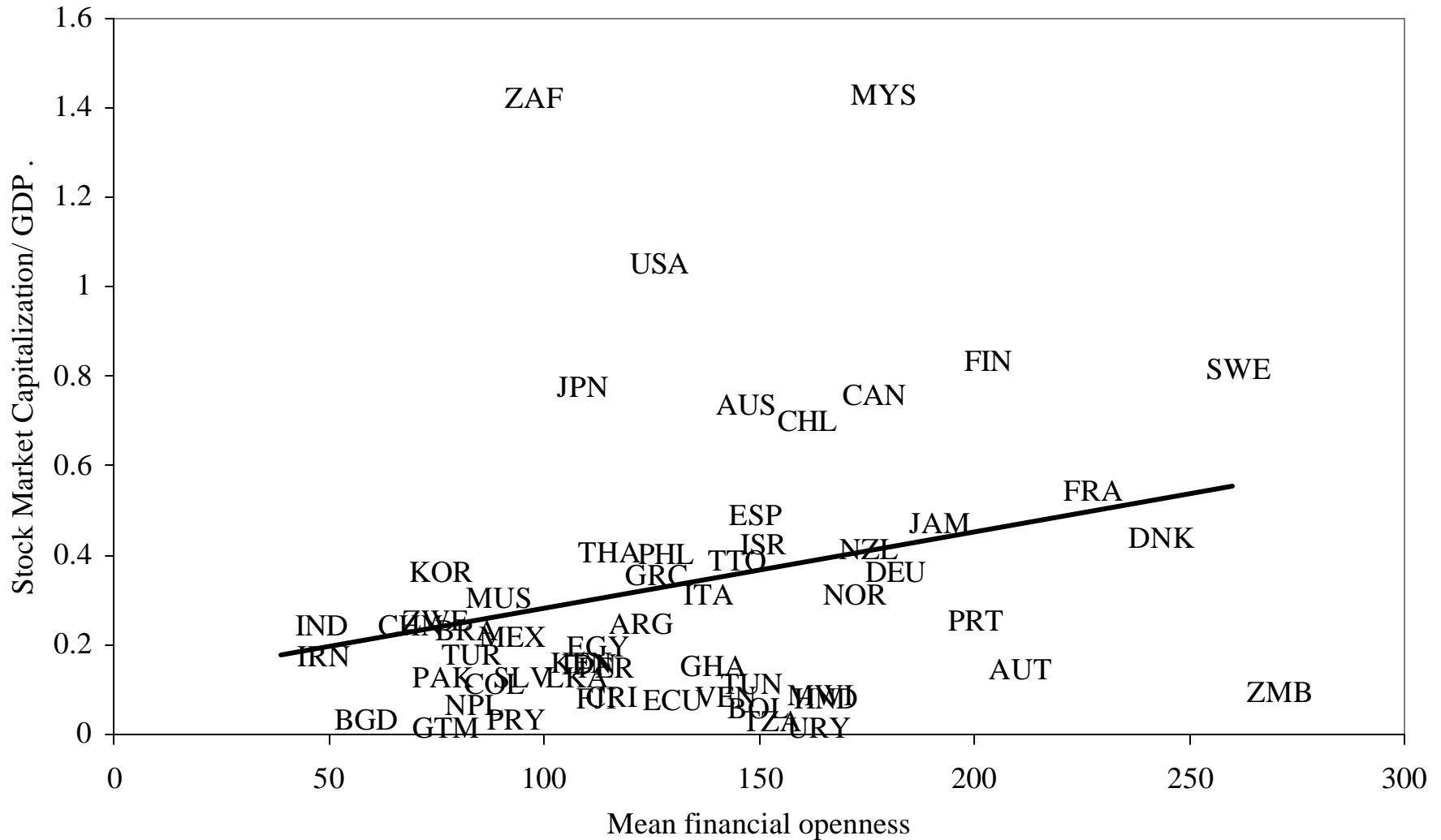


Figure 6A. Financial Openness and Financial Development: 1985-2004
Stock Market Capitalization/ GDP



FG and Quality of Institutions, Governance

- Openness to foreign capital provides incentives for improving corporate governance (Stulz)
- Corruption, lack of transparency discourage FDI, portfolio flows (Wei)

Figure 6B. Financial Openness and Quality of Institutions: 1985-2004
Institutional Quality

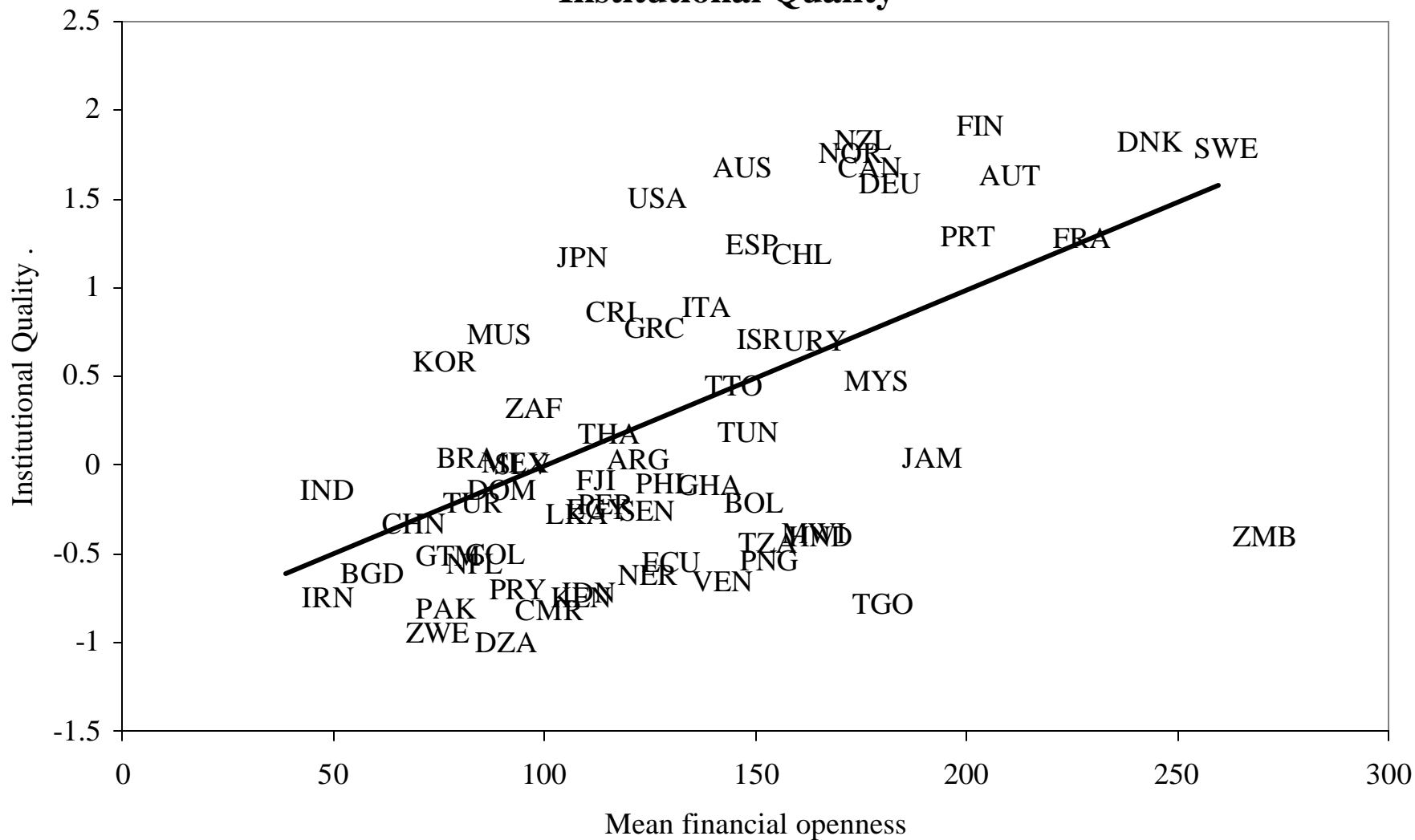
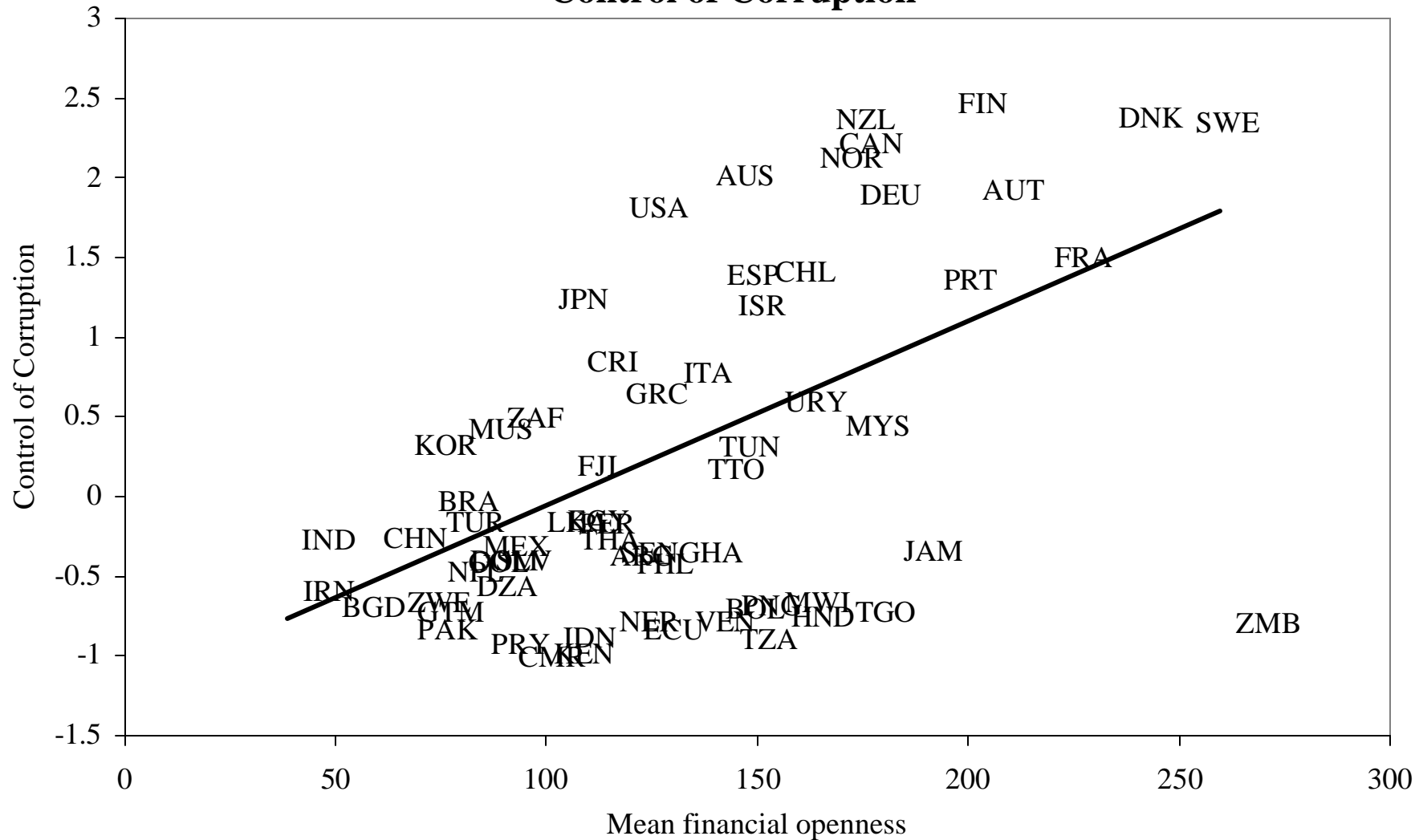


Figure 6B. Financial Openness and Quality of Institutions: 1985-2004
Control of Corruption



Macroeconomic Policy Discipline

- Capital account liberalization as commitment device
- Even Stiglitz is on board!
- Sadly, limited evidence

Figure 6C. Financial Openness and Macroeconomic Policies: 1985-2004
Monetary Policy

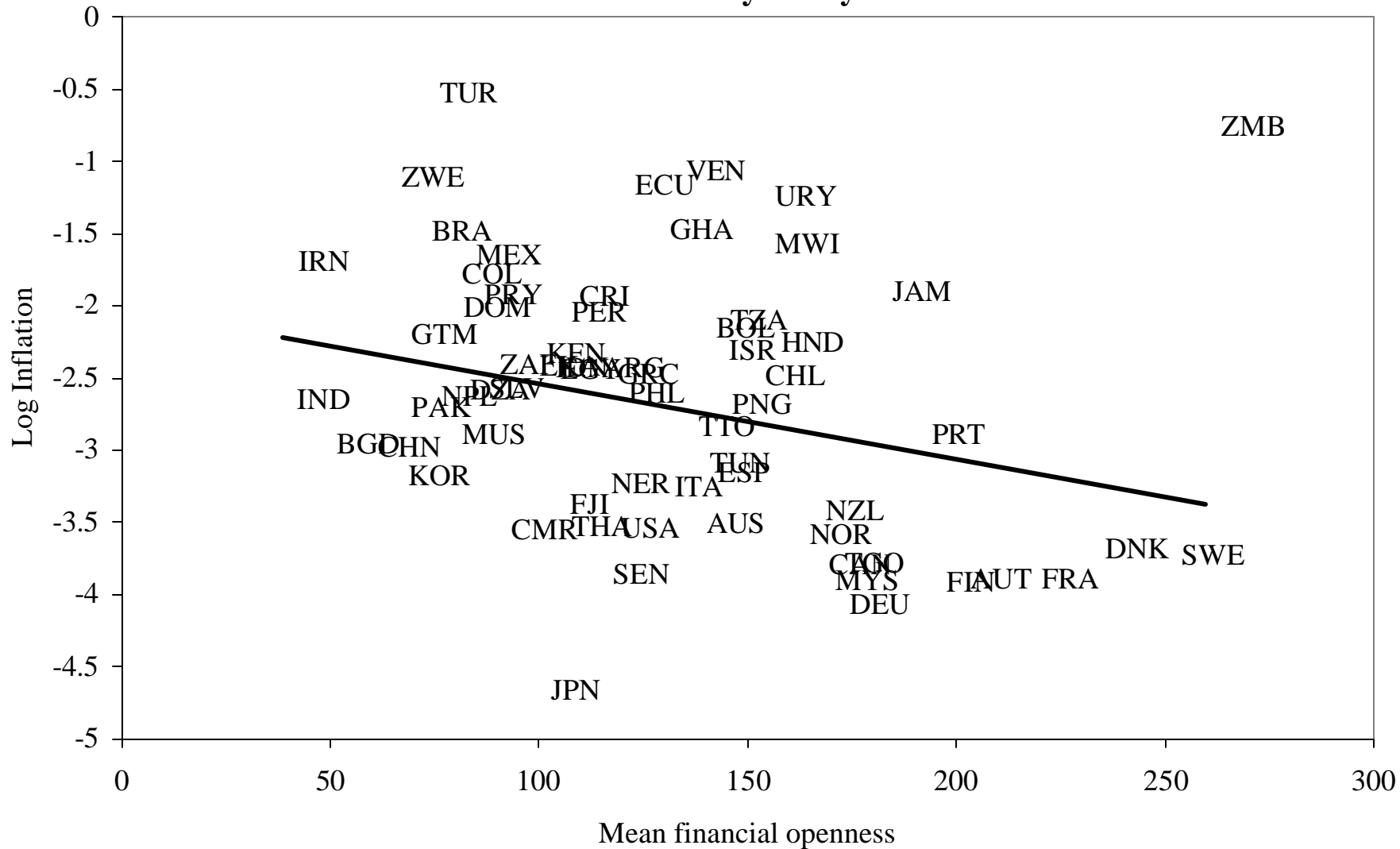
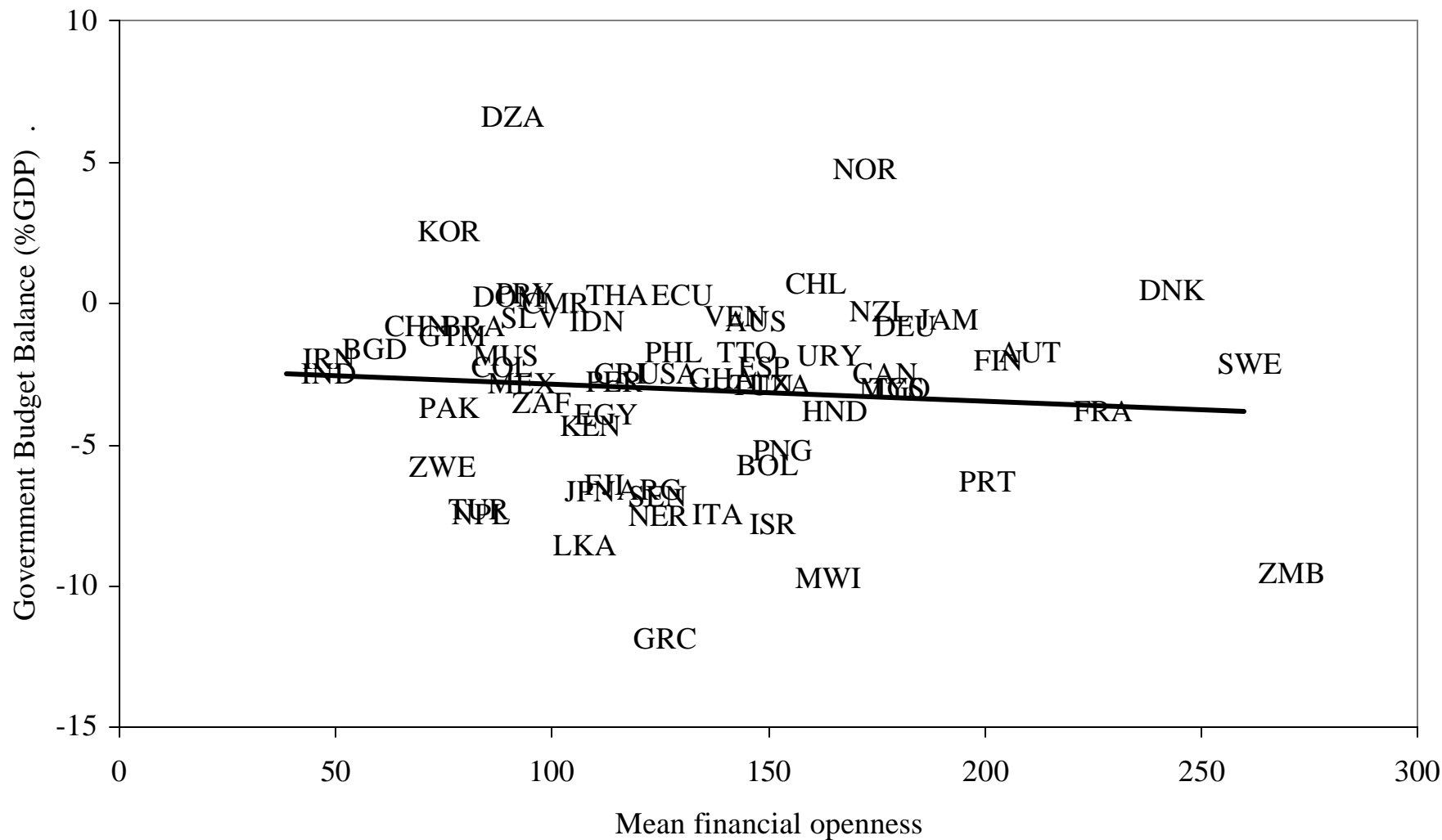
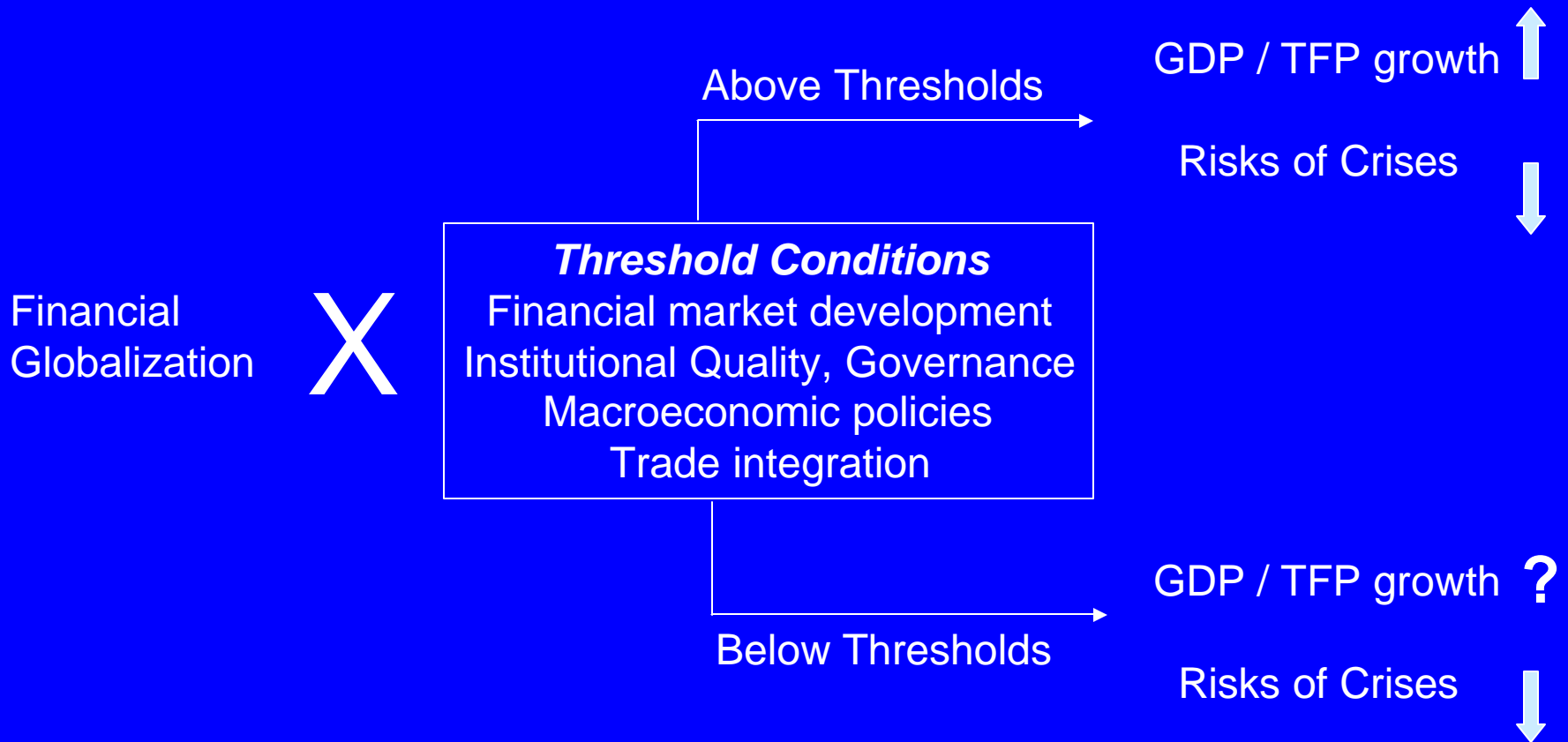


Figure 6C. Financial Openness and Macroeconomic Policies: 1985-2004
Fiscal Policy



Complication: Threshold Effects



How do Thresholds Affect Growth?

- Financial Market Development
 - Allocates financial flows efficiently
 - Enhances macroeconomic stability
- Institutional Quality
 - Affects the volume and stability of financial flows
 - Shifts the composition of flows towards FDI and equity
- Trade Openness
 - Makes less vulnerable to sudden stops
 - Mitigates the adverse effects of financial crises

TENSION !!

- Some evidence that financial integration catalyzes financial development, improves governance, imposes discipline on macro policies...
- But, in the absence of a basic pre-existing level of these supporting conditions, financial integration can wreak havoc

Empirical Literature on Thresholds

- How to make comparisons across studies?
- What are the relevant confidence intervals for thresholds?
- Are there trade-offs among threshold variables?
- What are the general policy implications?

	Financial Development Private credit/GDP	Institutional Quality WB composite index	Regulation Employment flexibility	Trade openness Trade policy openness	Overall development Initial income per capita
<i>Industrial:</i>					
Germany	Green	Green	Green	Green	Green
Japan	Green	Green	Green	Green	Green
USA	Green	Green	Green	Green	Green
<i>MFI:</i>					
Argentina	Red	Red	Green	Green	Green
Brazil	Green	Red	Green	Green	Green
Chile	Green	Green	Green	Green	Green
China	Green	Red	Green	Red	Red
Hong Kong	Green	Green	Green	Green	Green
India	Green	Red	Green	Red	Red
Indonesia	Green	Red	Green	Green	Red
Korea, Rep.	Green	Green	Green	Green	Green
Mexico	Red	Red	Green	Green	Green
Singapore	Green	Green	Green	Green	Green
South Africa	Green	Green	Green	Green	Green
Thailand	Green	Red	Green	Green	Red
Turkey	Red	Red	Green	Green	Green
<i>LFI:</i>					
Bangladesh	Red	Red	Green	Red	Red
Kenya	Green	Red	Green	Red	Red
Paraguay	Red	Red	Green	Green	Green
Tunisia	Green	Red	Green	Green	Green

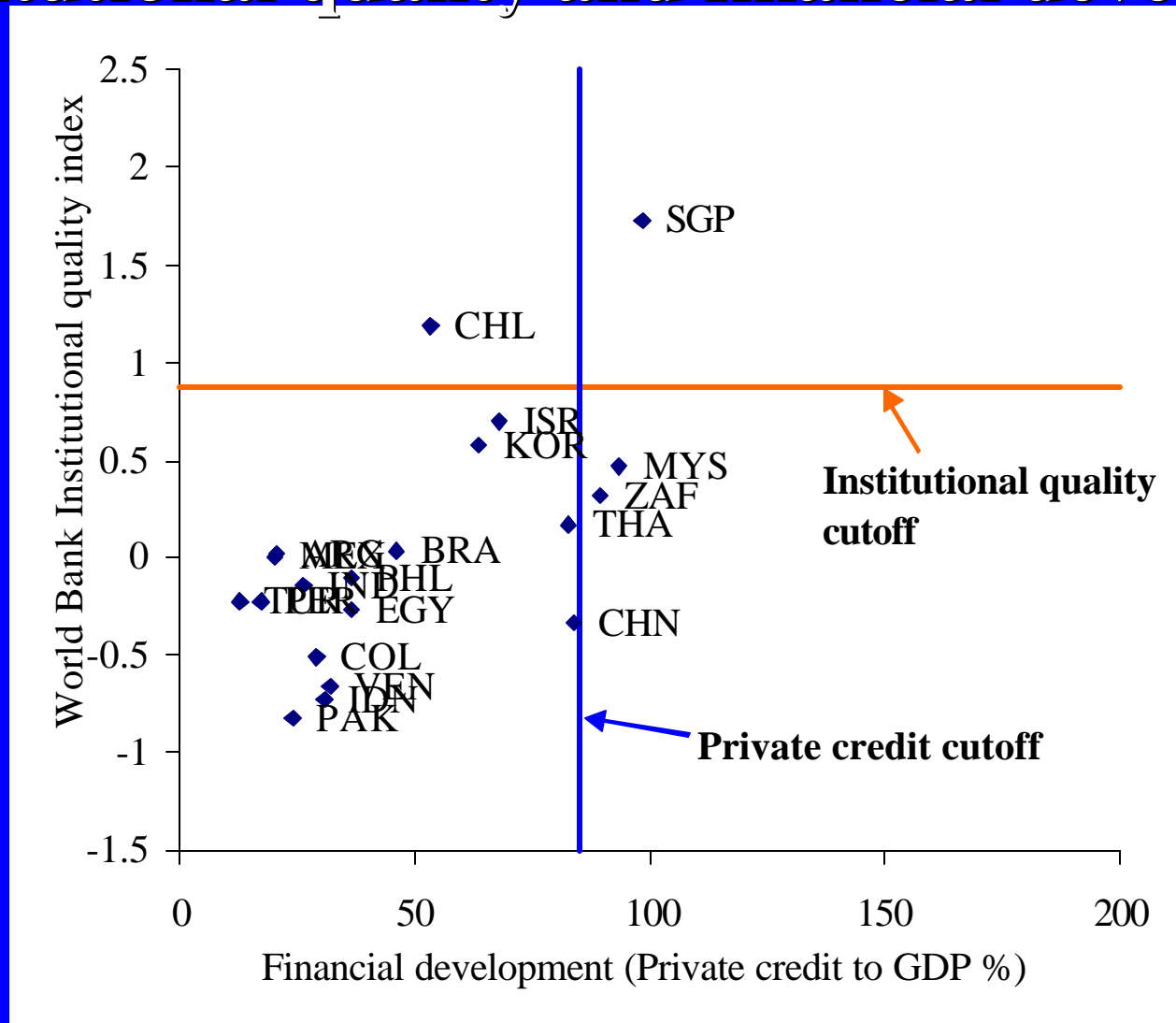


Above linear threshold



Below linear threshold

Multiple potential thresholds: Institutional quality and financial development



Data are full sample averages. Linear cutoffs calculated using total external liabilities to GDP as financial openness measure.

Further Work Needed

- Identification of thresholds
- Interactions/trade-offs among thresholds
- Level of integration itself is a threshold

Implications for Macro Policies

- Outcomes of financial globalization better under “sound” macro policies. What does “sound” mean? Are results robust?
- Countries with large buildup of (foreign- denominated) debt more vulnerable to financial crises
- Fixed exchange rate regimes increase vulnerability to financial/currency crises
- Inflation targeting with flexible exchange rates delivers best long-run outcomes; but short-run complications not easy to avoid
- Alternative views: Institutional development (Acemoglu et al, 2003), level of human capital (Glaeser et al, 2004) more important

Capital Controls

- Do they have a role as a policy tool to:
 - > Reduce volumes of inflows/outflows
 - > Change composition, maturity of flows
 - > Reduce pressure on exchange rate
 - > Allow for more independent monetary policy
- Macroeconomic vs microeconomic evidence

Empirical Literature

- Studies using macro data
 - Evidence inconclusive
 - Exchange controls are negatively associated with trade volume
- Controls as non-tariff barriers
- Studies using micro data
 - Capital controls result in large efficiency losses (Forbes, 2005)
 - Distortions, administrative costs, insulate economy from competitive forces and reduce market discipline, corruption
 - Cost of capital is higher for multinationals when controls in place (Desai, Foley and Hines, 2004)

Bottom Line on Capital Controls

- Can have some effect on composition and maturity structure of inflows/outflows, but effect is at best short term
- Efficiency costs even in short run
- Effectiveness invariably eroded over time
- Can be counterproductive if not seen as part of broader policy package (may be seen as signal of policy instability)

Collateral Benefits Framework May Help Make Progress

- Unified conceptual framework
- Country-specific requirements, initial conditions can be taken into account
- Selective approach to liberalization based on prioritization of collateral benefits
- Can manage risks during transition to thresholds, but can not eliminate them

Broader Policy Messages

- Essential to see financial integration not just as an isolated policy goal but as part of a broader package of policies/reforms
- Financial integration can support/stimulate/catalyze other reforms
- Financial integration not an end in itself. ;If not put in the context of a more complete policy/reform agenda, could reduce its benefits or even prove counterproductive

A Proposal: Securitizing Inflows

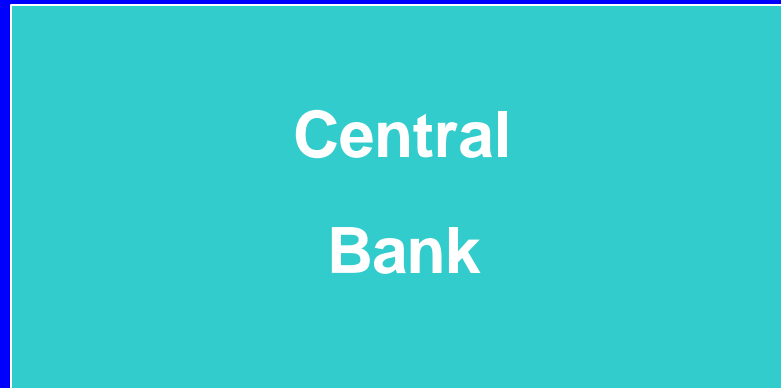
(Prasad and Rajan)

- Get benefits of inflows
- Reduce costs of sterilization
- Lower risks of liberalization of outflows

Inflows



Reserves

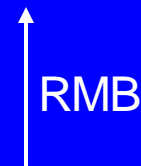


Central

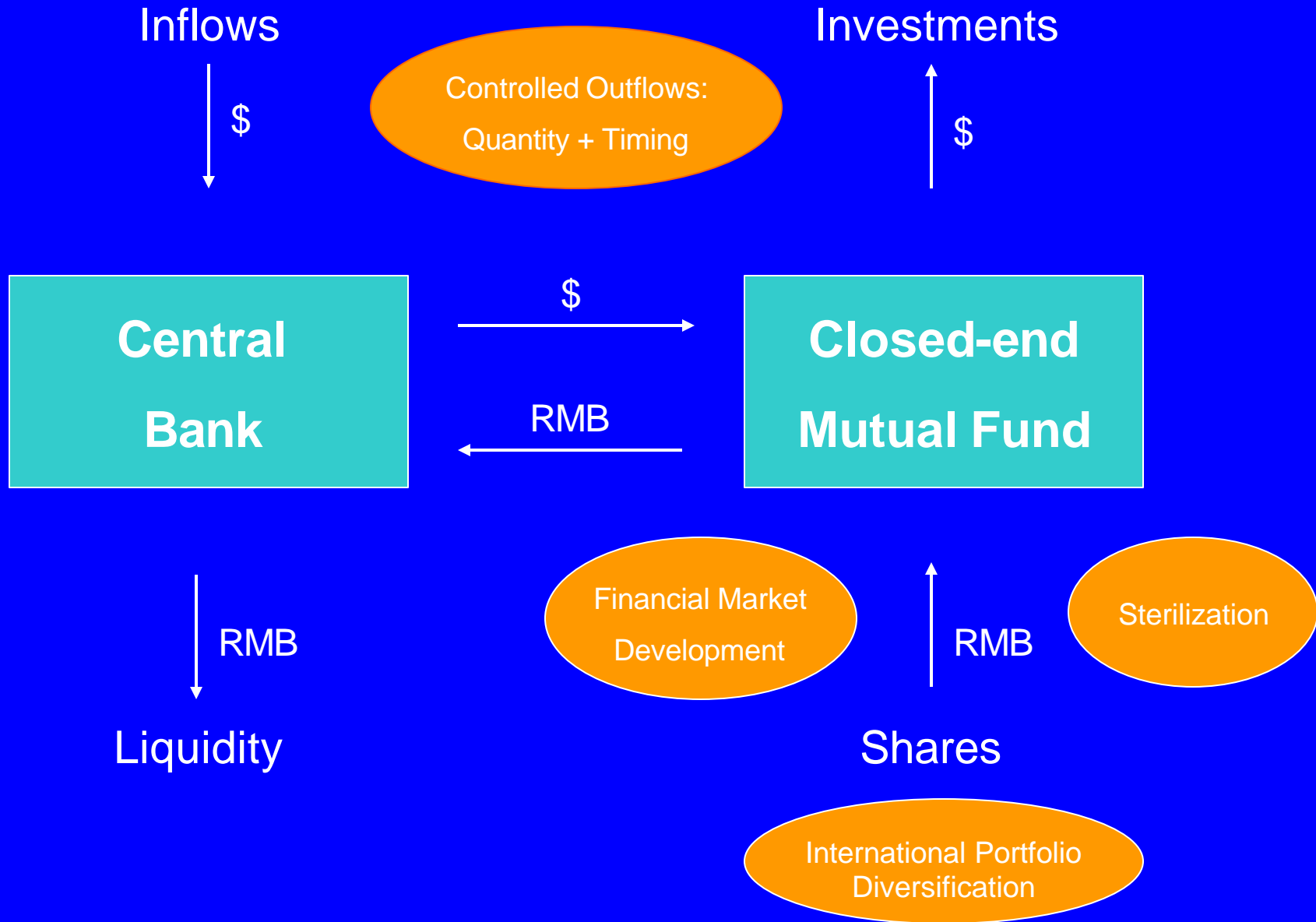
Bank



Liquidity



CB Bills



Proposal for Securitizing Inflows

Other Benefits

- Provides breathing room for some macroeconomic reforms (fx flexibility)
- Easier to recycle inflows; less need for controls on inflows
- Fx risk taken off Central Bank's balance sheet
- Securitizing inflows may enhance benefits in terms of reduction in cost of external borrowing
- Could complement other approaches such as QDII