

## **Financial Globalization: Beyond the Blame Game**

A new way of looking at financial globalization reexamines its costs and benefits

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Financial globalization—the phenomenon of rising cross-border financial flows—is often blamed for the string of damaging economic crises that rocked a number of emerging markets in the late 1980s in Latin America and in the 1990s in Mexico and a handful of Asian countries. The market turmoil and resulting bankruptcies prompted a rash of finger pointing by those who suggested that developing countries had dismantled capital controls too hastily—leaving themselves vulnerable to the harsh dictates of rapid capital movements and market herd effects. Some were openly critical of international institutions they saw as promoting capital account liberalization without stressing the necessity of building up the strong institutions needed to steer markets through bad times.

In contrast to the growing consensus among academic economists that trade liberalization is by and large beneficial for both industrial and developing economies, debate rages among academics and practitioners about the costs and benefits of financial globalization. Some economists (for example, Dani Rodrik, Jagdish Bhagwati, and Joseph Stiglitz) view unfettered capital flows as disruptive to global financial stability, leading to calls for capital controls and other curbs on international asset trade. Others (including Stanley Fischer and Lawrence Summers) argue that increased openness to capital flows has, in general, proven essential for countries seeking to rise from lower- to middle-income status and that it has strengthened stability among industrial countries. This debate clearly has considerable relevance for economic policy, especially given that major economies like China and India have recently taken steps to open up their capital accounts.

To get beyond the polemics, we put together a framework for analyzing the vast and growing body of studies about the costs and benefits of financial globalization. Our framework offers a fresh perspective on the macroeconomic effects of global financial flows, in terms of both growth and volatility. We systematically sift through various pieces of evidence on whether developing countries can benefit from financial globalization and whether financial globalization, in itself, leads to economic crises. Our findings suggest that financial globalization appears to be neither a magic bullet to spur growth, as some proponents would claim, nor an unmanageable risk, as others have sought to portray it.

### **Unanswered questions**

The recent wave of financial globalization began in earnest in the mid-1980s, spurred by the liberalization of capital controls in many countries in anticipation of the better growth outcomes and increased stability of consumption that cross-border flows would bring. It was presumed that these benefits would be large, especially for developing countries, which tend to be more capital-poor and have more volatile income growth than other countries.

Emerging market economies, the group of developing countries that have actively participated in financial globalization, have clearly registered better growth outcomes, on average, than those countries that have not (see Chart 1). Yet the majority of studies using cross-country growth regressions to analyze the relationship between growth and financial openness have been unable to show that capital account liberalization produces measurable growth benefits. One reason may be traced to the difficulty of measuring financial openness. For example, widely-used measures of capital controls (restrictions on capital account transactions) fail to capture how effectively countries enforce those controls and do not always reflect the actual degree of an economy's integration with international capital markets. In recent years, considerable progress has been made on developing better measures of capital controls and better data on flows and stocks of international assets and liabilities. Studies that are based on these improved measures of financial integration are beginning to find evidence of positive growth effects of financial integration. The evidence, however, is still far from conclusive.

Nor is there systematic evidence that financial integration is the proximate determinant of financial crises. Authors who have looked at different manifestations of such crises—including sudden stops of capital inflows, current account reversals, and banking crises—have found no evidence that countries that are more open to financial flows tend to have a higher incidence of crises than those that are less open. Although crisis episodes receive most of the attention, they are just particularly sharp manifestations of the more general phenomenon of macroeconomic volatility. On that score, the results are less favorable—financial globalization has not delivered on the promised benefit of improved international risk sharing and reduced volatility of consumption for developing countries.

In sum, the effects of financial globalization have not been conclusively determined. On the one hand, there is little formal empirical evidence to support the oft-cited claims that financial globalization has *caused* the financial crises that the world has seen over the past three decades. On the other hand, the existence of robust macroeconomic evidence of the benefits of financial globalization is elusive. Given the shortcomings of cross-country growth regressions, is there another approach that can shed light on the effects of financial globalization?

### **Not created equal**

An alternative perspective on the growth and volatility effects of financial globalization is based on differentiating among various types of capital flows. This is particularly relevant as the composition of international financial flows has changed markedly over time.

*Foreign direct investment* (FDI) has now become the dominant source of private capital flows to emerging market economies (see Chart 2); *equity flows* have also risen in importance, whereas *debt flows* have declined. FDI and portfolio equity flows are presumed to be more stable and less prone to reversals and are believed to bring with them many of the indirect benefits of financial globalization, such as transfers of managerial and technological expertise. Debt flows, by contrast, are widely accepted as being riskier; in particular, the fact

that they are procyclical and highly volatile can magnify the adverse impact of negative shocks on economic growth.

The increasing importance of portfolio equity flows to emerging markets has motivated a number of studies examining the growth effects of equity market liberalizations. These papers uniformly suggest that these liberalizations have a significant, positive impact on output growth. Whether the estimated growth effects could be picking up the effects of other factors—especially other reforms that tend to accompany these liberalizations—remains, in our view, an open question. On the other hand, the body of microeconomic evidence (using industry- and firm-level data) supporting the macro evidence of the benefits of equity liberalizations is growing. Some of these papers also document the empirical relevance of various theoretical channels that link equity market liberalization to economic growth—including through increases in investment and total factor productivity growth.

Interestingly, despite the general consensus that FDI is most likely to spin off positive growth benefits, these benefits are harder to detect in aggregate data than those associated with equity flows. Fortunately, recent research using micro data is starting to confirm that FDI flows do have significant spillover effects on output and productivity growth.

From the evidence we have reviewed thus far, a key theme emerges: many of the benefits of financial openness seem to be masked in cross-country analysis using macroeconomic data but are more apparent in disaggregated analyses using micro data. An approach based on micro data also has a better chance of disentangling causal effects and capturing the relative importance of different channels through which financial integration affects growth.

Some economists have used micro data to estimate the costs of capital controls. Such controls seem to cause distortions in the behavior of firms (and individuals), which adjust their behavior to evade capital controls. By insulating an economy from competitive forces, capital controls may also reduce market discipline. Thus, their existence appears to result in significant efficiency costs at the level of individual firms or sectors.

### **Making sense of the evidence**

We now introduce a conceptual framework that assembles these disparate strands of evidence and may shed some light on why empirical evidence at different levels of disaggregation reaches different conclusions.

A basic building block of our framework is the notion that successful financial globalization does not simply enhance access to financing for domestic investment but that its benefits are catalytic and indirect. Far more important than the direct growth effects of access to more capital is how capital flows generate what we label financial integration's potential *collateral benefits* (so called because they may not be countries' primary motivations for undertaking financial integration). A growing number of studies are showing that financial openness can promote development of the domestic financial sector, impose

discipline on macroeconomic policies, generate efficiency gains among domestic firms by exposing them to competition from foreign entrants, and unleash forces that result in better government and corporate governance. These collateral benefits could enhance efficiency and, by extension, total factor productivity growth.

The notion that financial globalization influences growth mainly through indirect channels has powerful implications for an empirical analysis of its benefits. Building institutions, enhancing market discipline, and deepening the financial sector take time, as does the realization of growth benefits from such channels. This may explain why, over relatively short periods, it seems much easier to detect the costs but not the benefits of financial globalization. More fundamentally, even at long horizons, it may be difficult to detect the productivity-enhancing benefits of financial globalization in empirical work if one includes structural, institutional, and macroeconomic policy variables in cross-country regressions that attempt to explain growth. After all, it is through these very channels that financial integration generates growth benefits (see Chart 3).

One should not, of course, overstate the case that financial integration generates collateral benefits. It is equally plausible that, all else being equal, more foreign capital tends to flow to countries with better-developed financial markets and institutions. We do not dismiss the importance of traditional channels—that financial integration can increase investment by relaxing the constraints imposed by low levels of domestic saving and reducing the cost of capital. But our view is that these traditional channels may have been overemphasized in previous research.

Is there empirical merit to our conceptual framework? We now turn our attention to marshalling the evidence for a key piece of our argument—that financial globalization has significant collateral benefits.

### **Financial integration's indirect benefits**

The potential indirect benefits of financial globalization are likely to be important in three key areas: financial sector development, institutional quality, and macroeconomic policies.

A good deal of research suggests that international financial flows serve as an important catalyst for domestic *financial market development*, as reflected both in straightforward measures of the size of the banking sector and equity markets and in broader concepts of financial market development, including supervision and regulation.

Research based on a variety of techniques, including country case studies, supports the notion that the larger the presence of foreign banks in a country, the better the quality of its financial services and the greater the efficiency of financial intermediation. As for equity markets, the overwhelming theoretical presumption is that foreign entry increases efficiency, and the evidence seems to support this channel. Stock markets do, in fact, tend to become larger and more liquid after equity market liberalizations.

The empirical evidence suggests that financial globalization has induced a number of countries to adjust their corporate governance structures in response to foreign competition and demands from international investors. Moreover, financial sector FDI from well-regulated and well-supervised source countries tends to support *institutional development and governance* in emerging market economies.

Capital account liberalization, by increasing the potential costs associated with weak policies and enhancing the benefits associated with good ones, should also impose discipline on macroeconomic policies. Precisely because capital account liberalization makes a country more vulnerable to sudden shifts in global investor sentiment, it can signal the country's commitment to *better macroeconomic policies* to mitigate the likelihood of such shifts and their adverse effects. Although the empirical evidence on this point is suggestive, however, it is sparse. Countries with higher levels of financial openness appear more likely to generate better monetary policy outcomes in terms of lower inflation, but there is no evidence of a systematic relationship between financial openness and better fiscal policies.

The evidence that we have surveyed in this section is hardly decisive, but it does consistently point to international financial integration as a catalyst for a variety of productivity-enhancing benefits. Given the difficulties that we have identified in interpreting the cross-country growth evidence, it is encouraging to see that financial market integration seems to be operating through some of the indirect channels.

### **A complication: thresholds**

Some related studies have tackled the question of what initial conditions are necessary if financial openness is to generate good growth benefits for a country while lowering the risks of a crisis. What are these conditions?

*Financial sector development*, in particular, is a key determinant of the extent of the growth and stability benefits financial globalization can bring. The more developed a country's financial sector, the greater the growth benefits of capital inflows and the lower the country's vulnerability to crises, through both direct and indirect channels.

Another benefit of greater financial sector development is that it has a positive effect on macroeconomic stability, which, in turn, has implications for the volume and composition of capital flows. In developing countries that lack deep financial sectors, sudden changes in the direction of capital flows tend to induce or exacerbate boom-bust cycles. Furthermore, inadequate or mismanaged domestic financial sector liberalizations have contributed to many crises that may be associated with financial integration.

*Institutional quality* appears to play an important role in determining not just the outcomes of financial integration but the actual level of integration. It also appears to strongly influence the composition of inflows into developing economies, which is another way it affects macroeconomic outcomes. Better institutional quality helps tilt a country's

capital structure toward FDI and portfolio equity flows, which tend to bring more of the collateral benefits of financial integration.

The *quality of domestic macroeconomic policies* also appears to influence the level and composition of inflows, as well as a country's vulnerability to crises. Sound fiscal and monetary policies increase the growth benefits of capital account liberalization and help avert crises in countries with open capital accounts. Moreover, for economies with weak financial systems, an open capital account and a fixed exchange rate regime are not an auspicious combination. A compelling case can be made that rigid exchange rate regimes can make a country more vulnerable to crises when it opens its capital markets.

*Trade integration* improves the cost-benefit trade-off associated with financial integration. It also reduces the probability of crises associated with financial openness and mitigates the costs of such crises if they do occur. Thus, recent studies strengthen the case made by the old sequencing literature that argued in favor of putting trade liberalization ahead of capital account liberalization.

This discussion suggests that there are some basic supporting conditions, or thresholds, that determine where on the continuum of potential costs and benefits a country ends up. It is the interaction between financial globalization and this set of initial conditions that determines growth and volatility outcomes (see Chart 4).

A comparison of Charts 3 and 4 highlights a fundamental tension between the costs and benefits of financial globalization. Most of the threshold conditions are identical to the collateral benefits. In other words, financial globalization is a catalyst for a number of important collateral benefits but can greatly elevate the risk-to-benefit ratio if the initial conditions in these dimensions are inadequate.

A different threshold is related to the level of integration itself. Industrial economies, which are far more integrated with global financial markets, clearly do a better job than emerging markets of using international capital flows to allocate capital efficiently, thereby accruing productivity gains and sharing income risk. Does this mean that, to realize the collateral benefits, developing countries' only hope is to attain a level of financial integration similar to that of industrial economies and that the risks they encounter along the way are unavoidable? After all, if the short-term costs take the form of crises, they could have persistent negative effects that detract from the long-term growth benefits. Furthermore, the distributional effects associated with these short-term consequences can be particularly painful for low-income countries.

### **Risk-benefit calculus**

Our synthesis of the literature on financial globalization, while guardedly positive about the overall benefits of financial globalization, suggests that as countries make the transition from being less integrated to being more integrated into global financial markets, they are likely to encounter major complications. For developing countries, financial globalization appears to

have the potential to generate an array of collateral benefits that may help boost long-run growth and welfare. At the same time, if a country opens its capital account without having some basic supporting conditions in place, the benefits can be delayed and the country can be more vulnerable to sudden stops of capital flows. This is a fundamental tension between the costs and benefits of financial globalization that may be difficult to avoid.

Does this imply that a country that wants the collateral benefits of financial globalization has no alternative but to expose itself to substantial risks of crises? Or, alternatively, would developing countries do best to shield themselves from external influences while trying to improve the quality of their domestic policies and institutions to some acceptable level? Our view is that, although the risks can never be totally avoided, there are ways to improve the benefit-risk calculus of financial globalization. There is, however, unlikely to be a uniform approach to opening the capital account that will work well for all countries.

The collateral benefits perspective may provide a way for moving forward on capital account liberalization that takes into account individual country circumstances (initial conditions) as well as the relative priorities of different collateral benefits for that country. Depending on a country's internal distortions--particularly those related to the domestic financial sector--one can, in principle, design an approach to capital account liberalization that could generate specific benefits while minimizing the associated risks. While we have laid out a framework for thinking about these issues, further research is clearly needed in a number of areas before one can derive strong policy conclusions about the specifics of such an approach. Meanwhile, we should recognize that some of the more extreme polemic claims made about the effects of financial globalization on developing countries, both pro and con, are far less easy to substantiate than either side generally cares to admit.

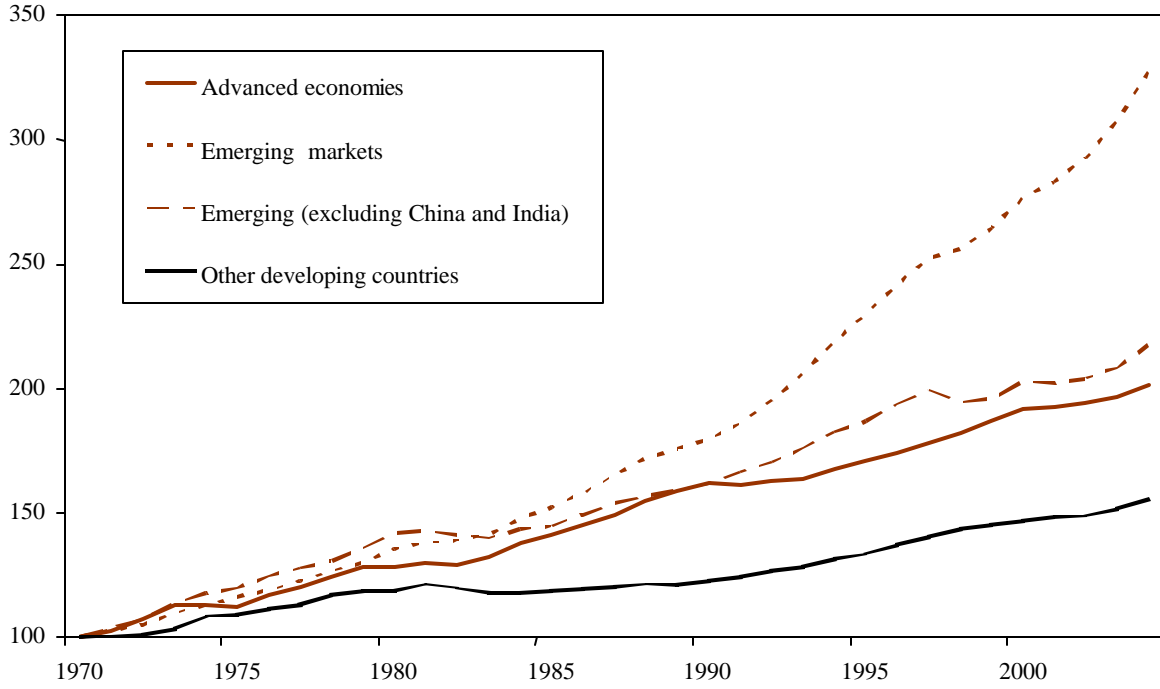
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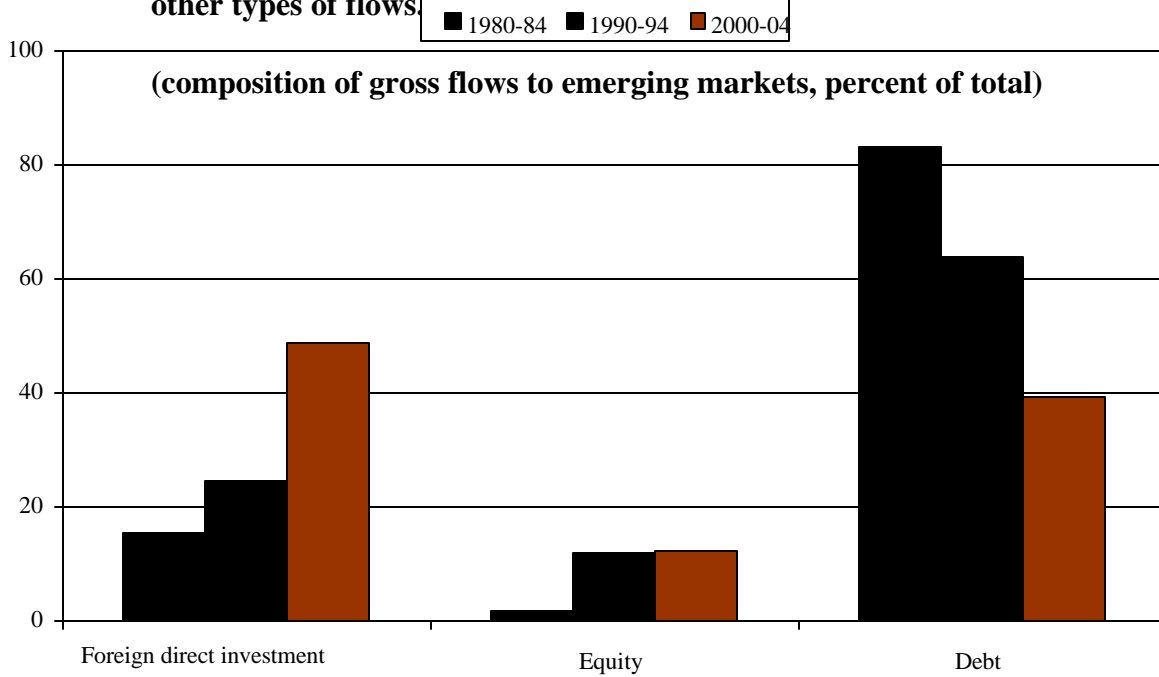
**Chart 1. Against the odds?**

**Despite crises in some emerging market countries, this group has outperformed other groups of countries over the past three decades.**

**(per capita GDP, weighted by purchasing power parity; 1970= 100)**

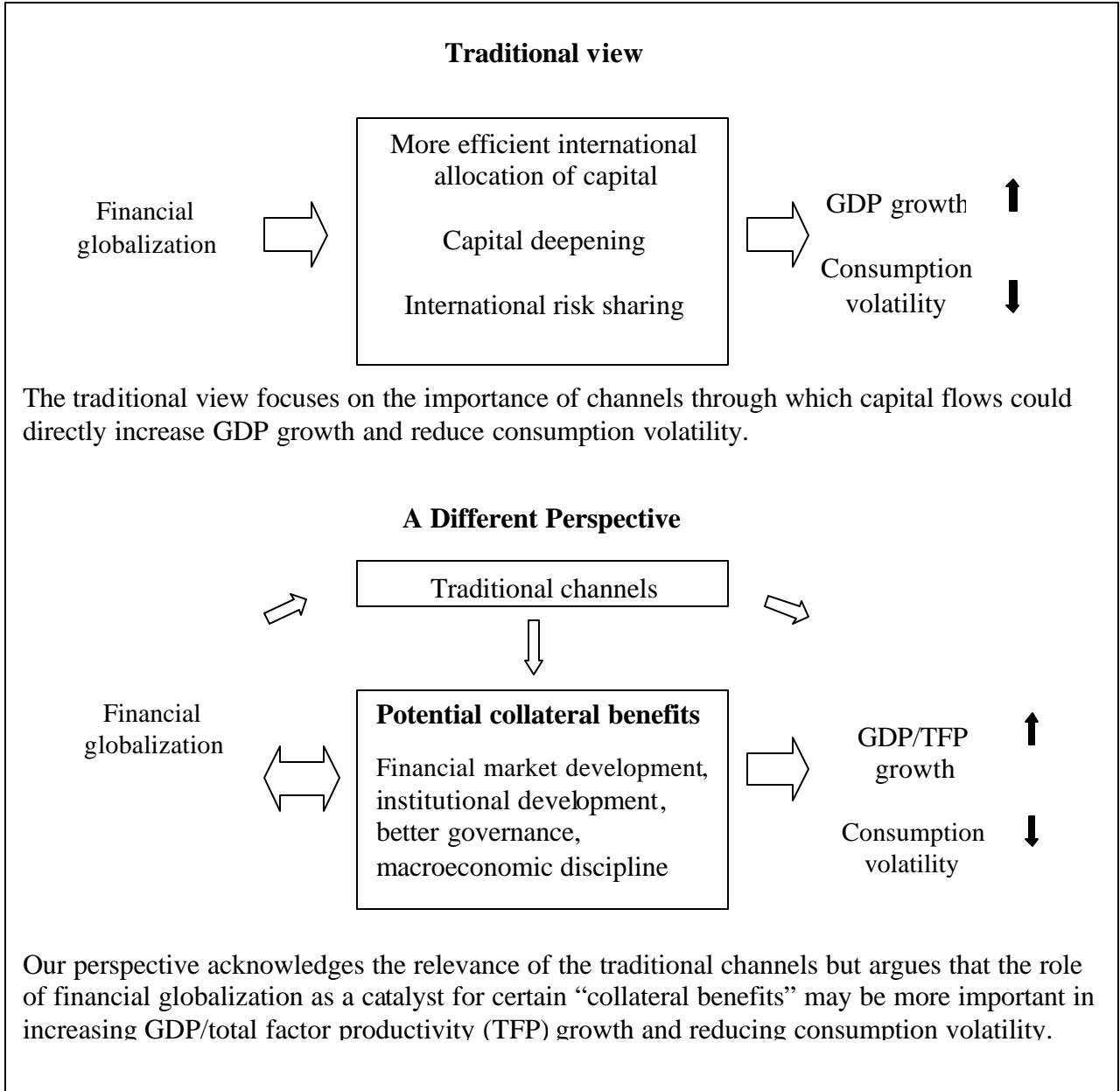


**Chart 2. On the rise**  
**Emerging market countries attract more foreign direct investment than other types of flows.**



**Chart 3**

Financial globalization yields collateral benefits ...



**Chart 4**

... but initial, or threshold, conditions are a complication

