New Perspectives on Financial Globalization

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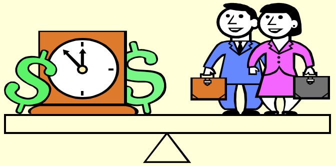
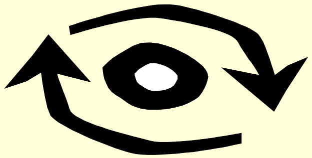
Six points

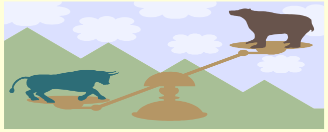
- "Financial markets good or bad" = straw man.
- Better approach to weigh pros & cons.



- We are now in the boom phase of the 3rd consecutive emerging-market cycle.

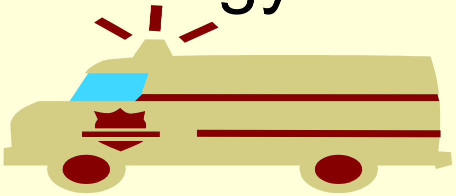


- "Is this time different?"



- Recent research: financial opening works best if countries have already achieved good institutions.

- All wisdom resides in the car crash analogy.



"Financial markets good or bad" is a straw man. To illustrate, let's play a game:

We will match the following names with quotes pointing out the limitations to international financial markets.

- Jagdish Bhagwati, Pro-globalization free trader
- George W. Bush, Republican president
- *The Economist* magazine
- Milton Friedman, Mr. Free Markets
- Ken Rogoff, et al, IMF study (2003)
- Robert Rubin, Secy. of the Treasury, 1996-1999
- Jeff Sachs, Mr. Shock Therapy
- George Soros, leading international speculator
- Lawrence Summers, Treasury Secy., 1999-2000
- James Tobin, Nobel-Prize winning economist
- Paul Volcker, FRB chairman, 1979-87
- Friederick von Hayek, libertarian
- John Williamson,“Washington consensus” (1990)

"…Market fundamentalists have a fundamentally flawed conception of how financial markets operate. … They attribute the fluctuations to external influences, so-called exogenous shocks… This view is plain wrong…There are times like the present when financial markets swing more like a wrecking ball than a pendulum, knocking over one economy after another."

George Soros

The Crisis of Global Capitalism (Public Affairs, NY) 1998

“…Liberalization of foreign financial flows is not regarded as a high priority.”

John Williamson

“What Washington Means by Policy Reform,” in Latin American Adjustment: How Much Has Happened, edited by Williamson (IIE, Washington DC, 1990) in his list of ten reforms that coined the phrase “Washington consensus.” (P.15)

"…International loan markets are prone to self-fulfilling crises, in which although individual creditors may act rationally, market outcomes produce sharp, costly, and fundamentally unnecessary panicked reversals in capital flows."

Jeff Sachs

S. Radelet & J. Sachs "The East Asian Financial Crisis: Diagnosis, Remedies, Prospects," BPEA, 1:1998. p.6-7 of pp.1-74.

“I remember -- when the Korean crisis first became serious -- calling people at a couple of the banks that had been extending credit to Korea, and it was astounding to me how little they knew about the country to which they had extended credit….When times are good, people reach, and when they reach, sooner or later it leads to excesses, and excesses sooner or later lead to trouble.”

Robert Rubin

in Economic and Financial Crises in Emerging Market Economies, M.Feldstein, ed. (U. Chicago Press: Chicago) 2002.

“Left alone, market forces will direct too much effort into speculation and too little into the development of new products…

Larry Summers

“Financial trading activity has increased enormously...Short-term speculation activity makes the market less stable...A tax of a half percent on exchange of financial securities... would take much of the juice out of the short-term trading game…”

Larry Summers

L.& V. Summers, 1989, “When Financial Markets Work Too well: A Cautious Case for A Securities Transactions Tax,” *J.Fin.Services Research*, 3, 261-286.

“While there is no proof in the data that financial globalization has benefited growth, there is evidence that some countries may have experienced greater consumption volatility as a result.”

Ken Rogoff, *et al*

“Effects of Financial Globalization on Developing Countries: Some Empirical Evidence,” E. Prasad, K. Rogoff, S.J. Wei, and M.A. Kose, Research Dept., IMF, 2003

"…The claims of enormous benefits from free capital mobility are not persuasive…[O]nly an untutored economist will argue that, therefore, free trade in widgets and life insurance policies is the same as free capital mobility. Capital flows are characterized…by panics and manias."

Jagdish Bhagwati

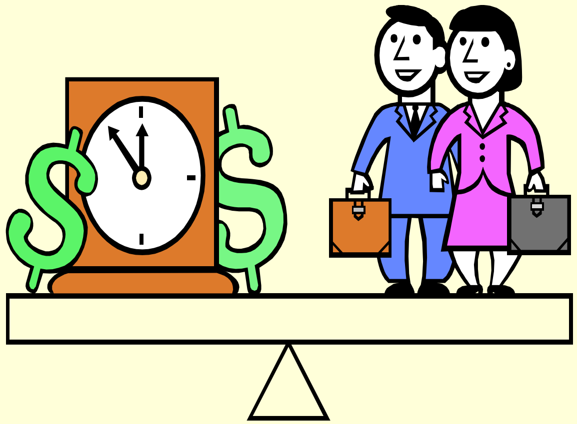
"The Capital Myth: The Difference between Trade in Widgets and Dollars," *Foreign Affairs* May 1998, 77, 3, p. 7-8 of 7-12.

"The capital market has vindicated its critics and embarrassed its would-be defenders too often of late. It has been responsible for, or at least deeply implicated in, some very costly economic breakdowns. Perhaps the anti-globalists are on to something."

The Economist magazine

"A Cruel Sea of Capital," May 3, 2003, p. 3.

It is a sterile debate to accuse others of believing that international financial markets work perfectly – or, for that matter, to accuse anyone who sees a useful role for public policy of failing to understand the virtues of free markets.



A better approach is to weigh the pros & cons of open international capital markets.

Advantages of financial integration

- For a country with high returns to domestic capital, borrowing abroad can **finance investment** more cheaply than can domestic saving alone.
- Investors in richer countries can earn a **higher rate of return on their saving**, investing in the emerging market, than they could domestically.
- Everyone benefits from the opportunity to **diversify** away risks and **smooth** disturbances.
- Letting foreign financial institutions in improves the efficiency of domestic financial markets. Over-regulated and potentially-inefficient domestic banks are subject to the harsh **discipline of competition**.
- Governments face the discipline of international capital markets if they make policy mistakes. "**Golden Straitjacket**"

International financial markets in practice may not work as claimed.

- The "**Lucas paradox**": capital often flows from poor countries (low K/L) to rich (high K/L)
- Capital flows empirically tend not to be countercyclical as in the intertemporal theory
  - Often **procyclical**, especially in developing countries.
  - Indeed, sometimes they are the source of the disturbance, not the smoother.
  - Sometimes, rather than disciplining governments, they aid & abet profligacy.
- Financial markets experience recurrent **disruptions**.

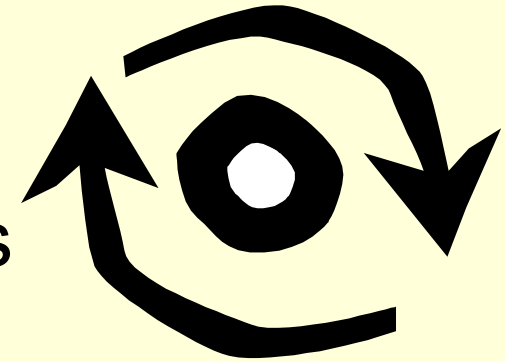
Recurrent disruptions in international financial markets, cont.

- E.g., the 1982 international debt crisis, 1992-93 European ERM crisis, 1994-95 Mexican peso crisis, 1997 Asian financial crisis, 1998 Russia, and 2001 Turkey & Argentina.
- It is hard to argue that investors punish countries when & only when the governments are following bad policies:
  - Large inflows often give way suddenly to large outflows, with little news appearing in between to explain the sentiment shift.
  - Contagion sometimes spreads to countries that are unrelated, or where fundamentals appear strong.
  - Recessions that have hit emerging market countries in such crises have been too big to argue that the system is working well.

We are now in the 3rd big consecutive cycle of capital inflows to developing countries

It's the biblical rule:

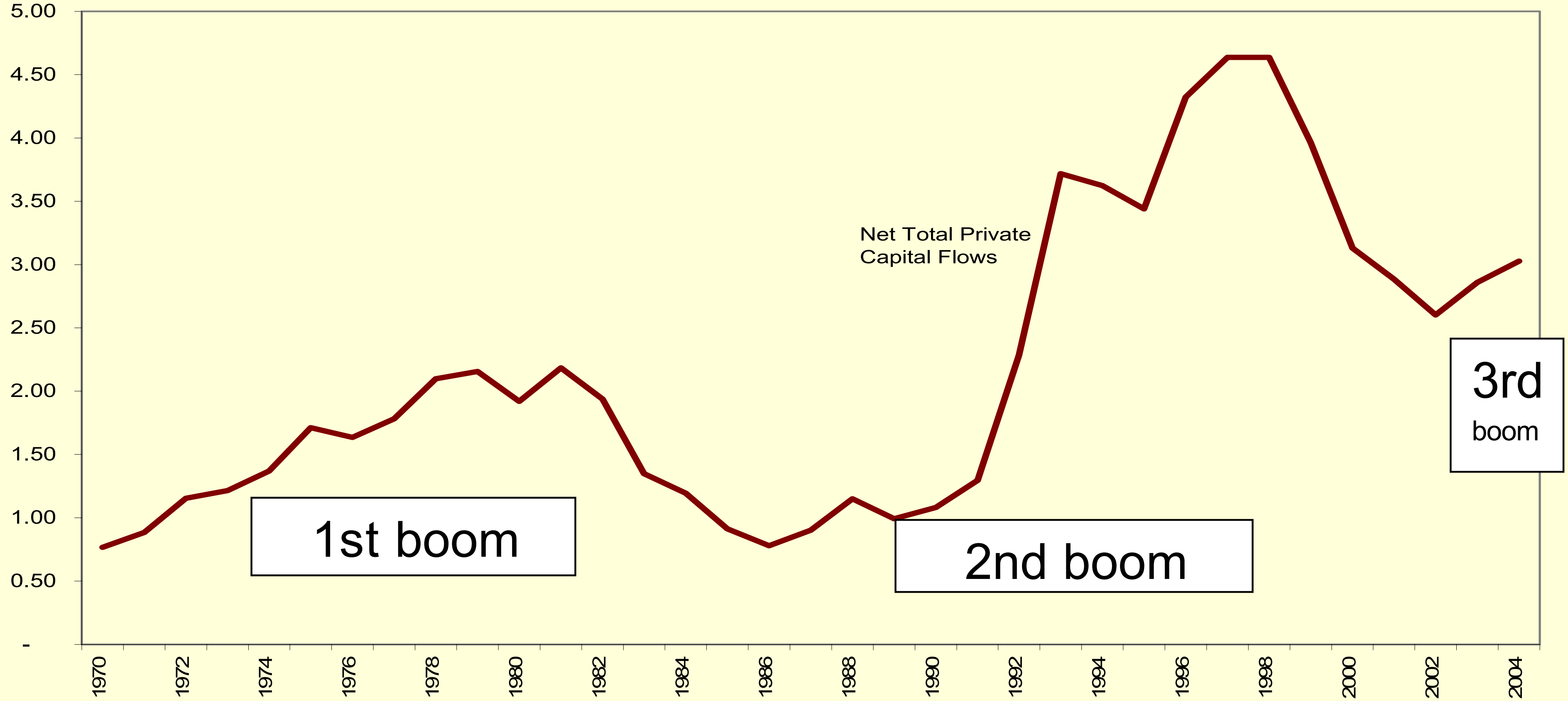
7 fat years followed by 7 lean years



1) Recycling petrodollars: 1975-81
   – 1982 crisis, then 7 lean years: -1989
2) Emerging market boom, 1990-96
   – 1997 crisis, then 7 lean years: -2003
3) Current boom, 2003-

The cycles show up in capital flow quantities

Capital Inflows to Developing Countries as percent of Total GDP (Low and Middle Income)



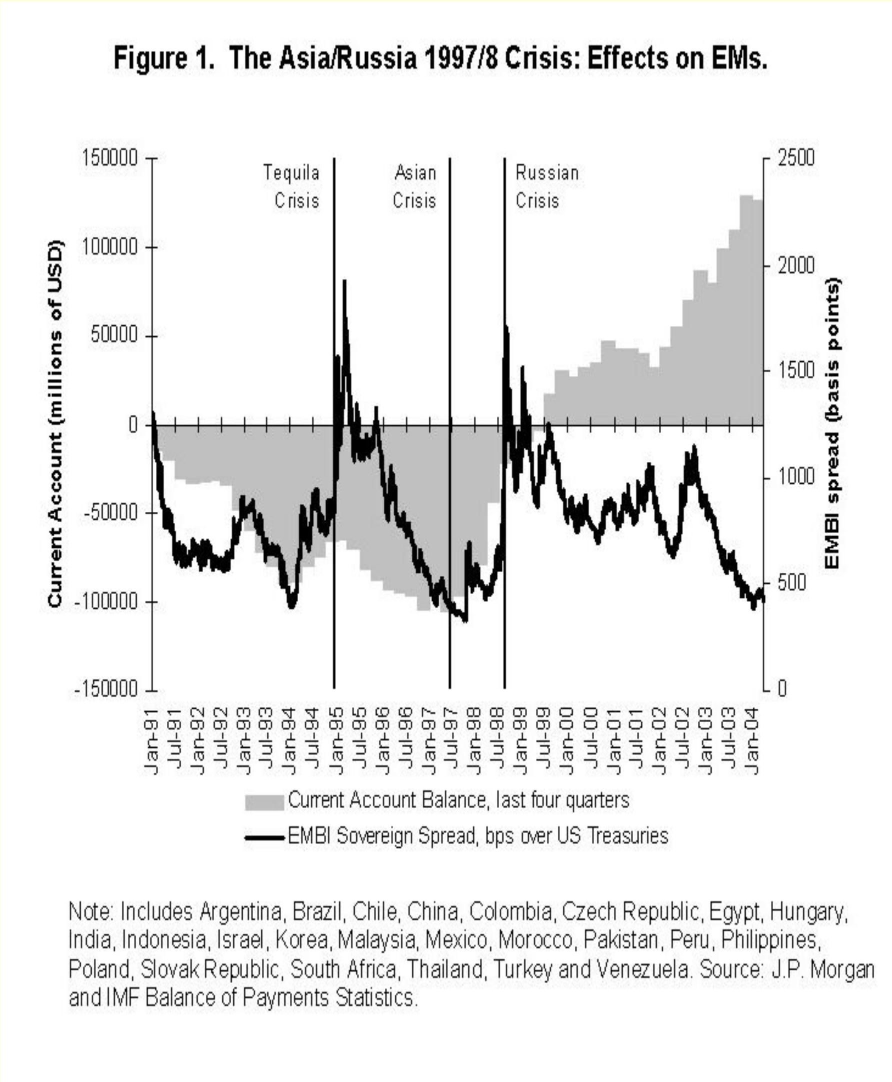
Source: World Development Indicators

They also show up in prices: sovereign spreads.

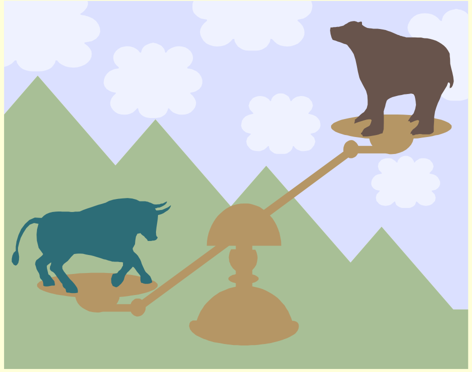
EMBI was up in 1995 & 98; down in 2003-07

Calvo, BIS, 2006

The Economist 2/22/07



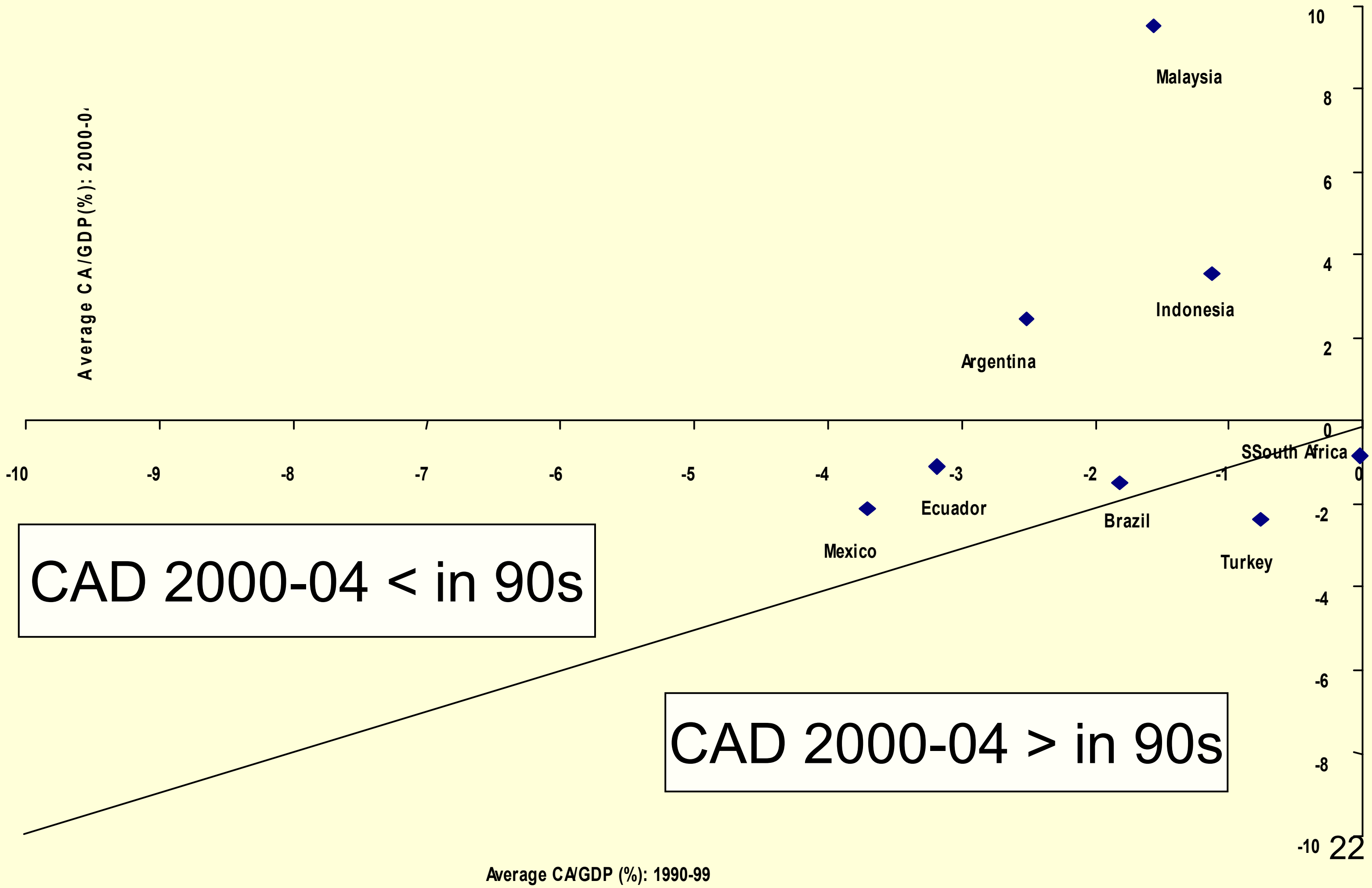
Is “this time different”?



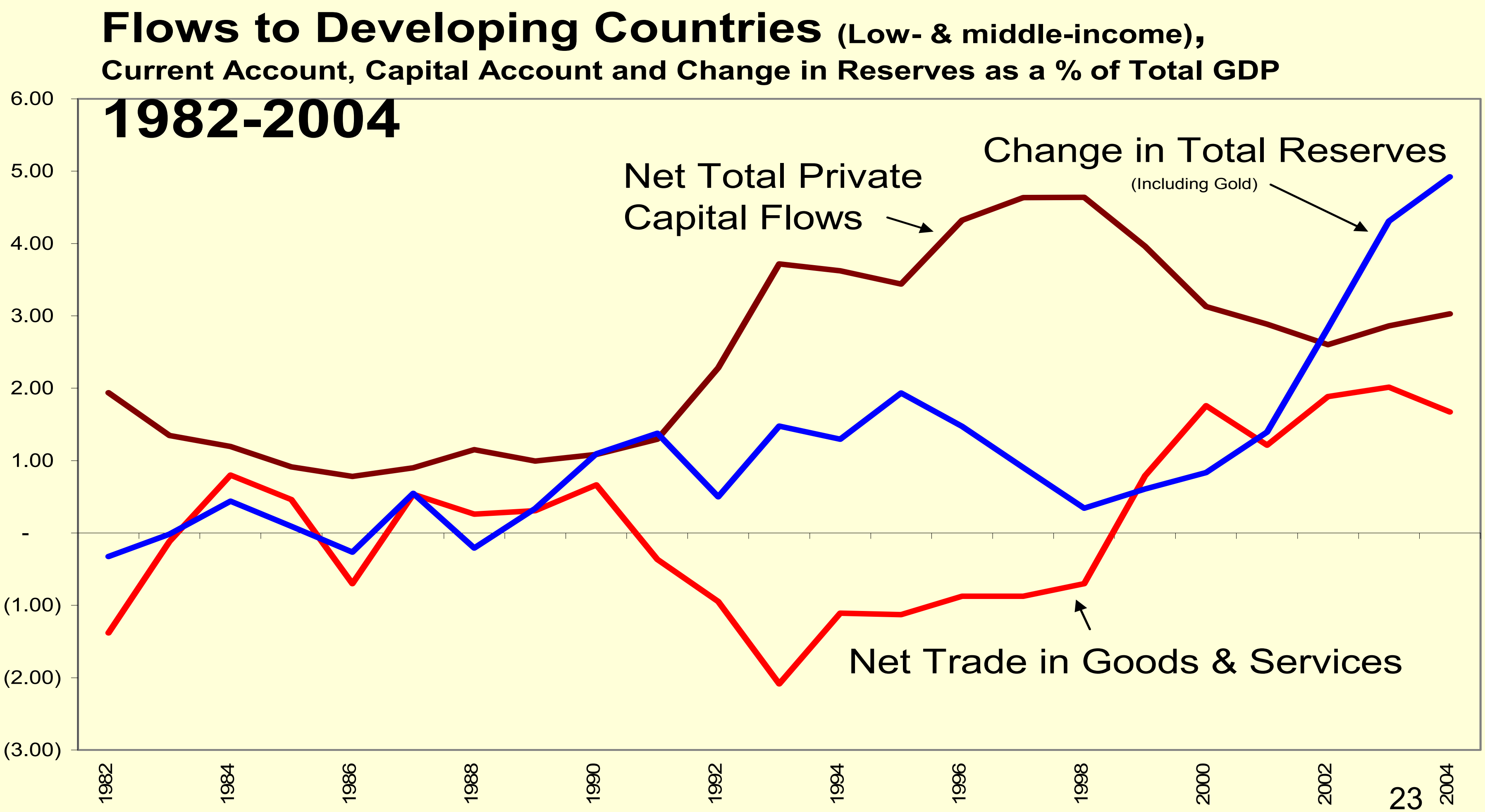
- Rogoff * says “no.”
- *Some* things *are* different this time:
  - Reserve holdings are much higher.
  - Despite this, exchange rates are more flexible.
  - Perhaps due to ex.rate volatility, more countries issue debt in domestic currency (vs.$)
  - More debt carries Collective Action Clauses
  - More openness to trade and FDI.

* ”This Time It’s Not Different,” *Newsweek International,* Feb.16, 2004

Most large emerging markets are not using the capital inflows to finance CA deficits as much as they did in the 1990s

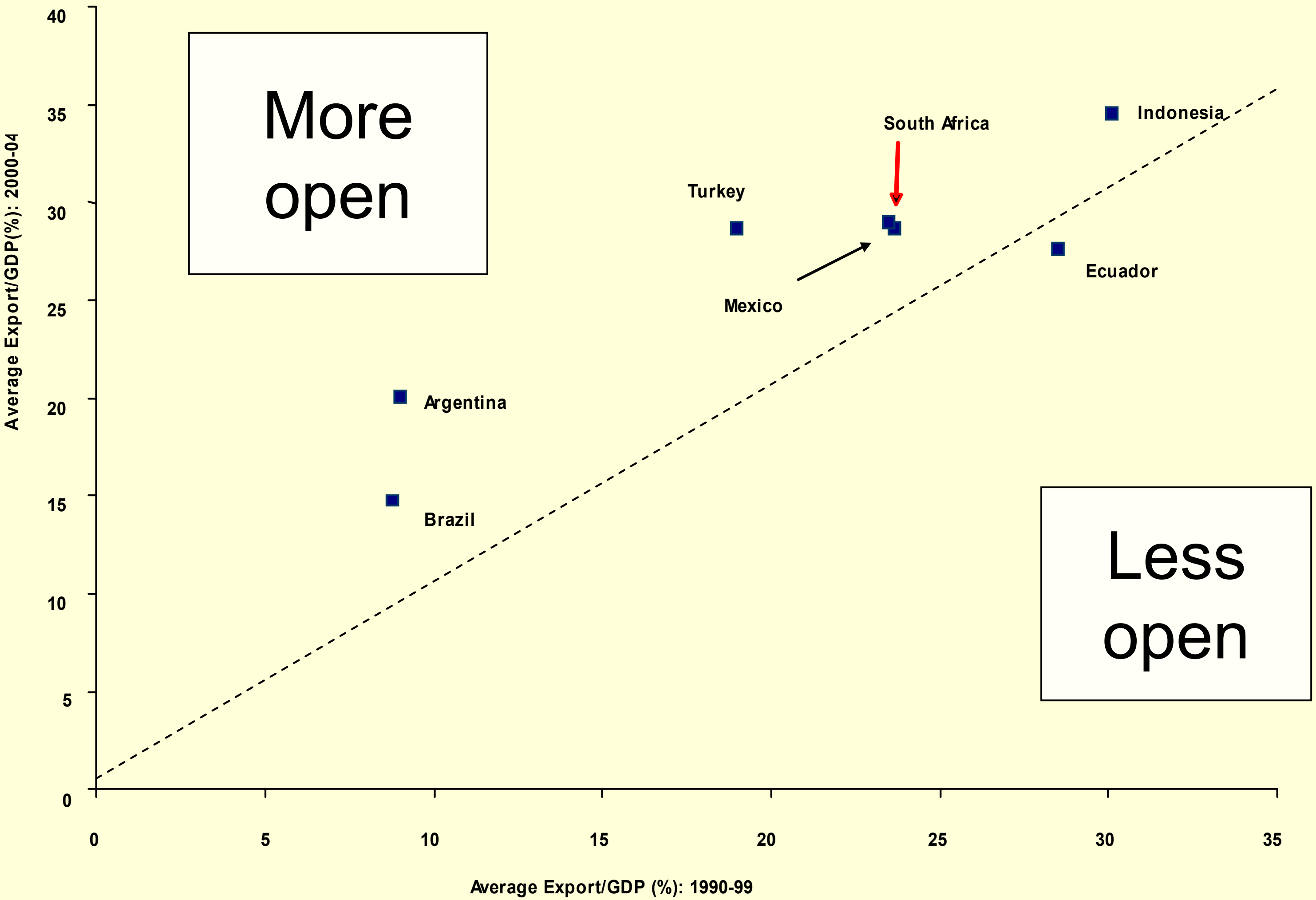


Instead, countries are using the inflows to build up forex reserves



Source: World Development Indicators

Export/GDP ratios 2000-04 > than in 1990s



New emerging market crises will come; but

- they won't necessarily be currency crises

(vs., e.g., crashes in land & securities markets).

- they won't necessarily be soon.

  Emerging markets are not yet ripe for new crises.
  - It is too soon. Memories are still fresh.

    Traders' jobs have not yet turned over.
  - Global monetary policy has been easy (as in the late 1970s & early 1990s).
  - Commodity prices are near historic peaks

Can recent research give us a verdict?

Peter Henry's work gets a very positive result, on average, for the case of countries opening their stock markets.

Effect on the cost of capital when countries open their stock markets to foreign investors -- P.Henry, Nov. 2006

Liberalization occurs in "Year 0"

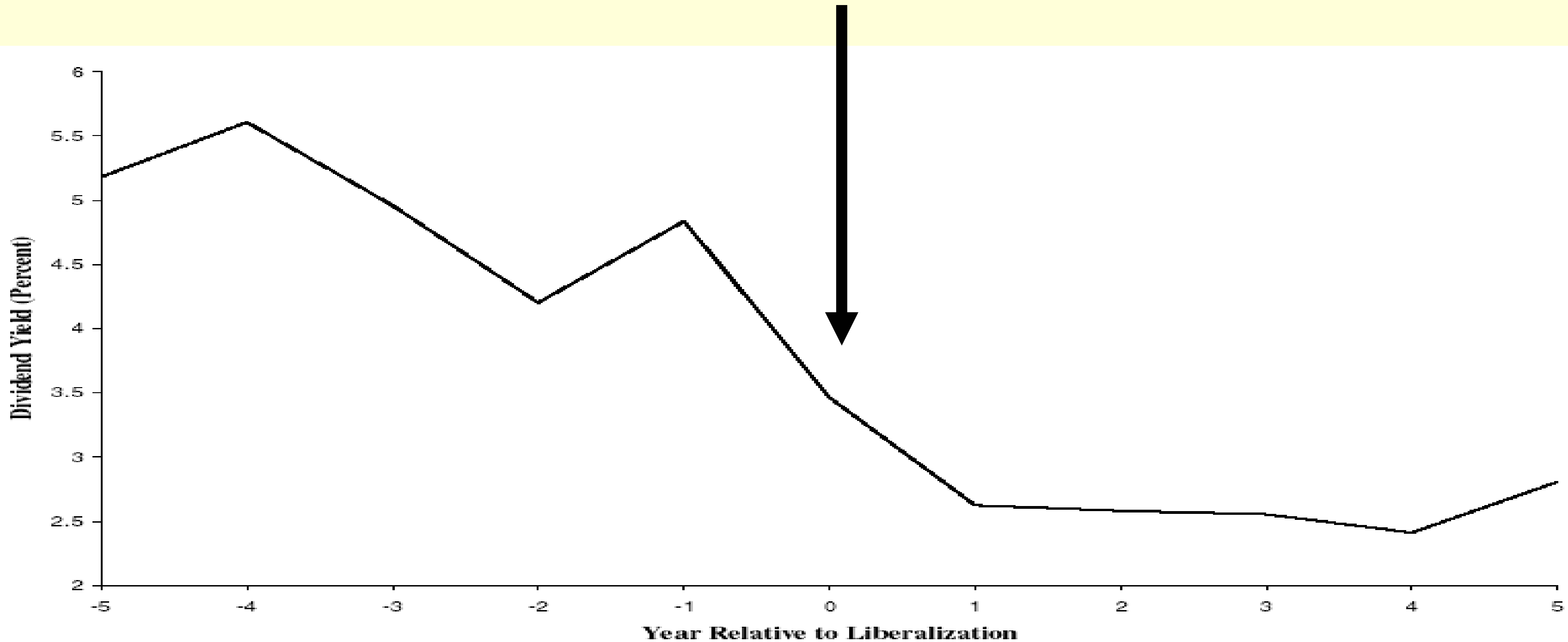


Figure 3. The Cost of Capital Capital Falls When Countries Liberalize the Capital Account.

Effect on investment when countries open their stock markets.

P.Henry, NBER WP 12698, Nov. 2006

Liberalization occurs in "Year 0"

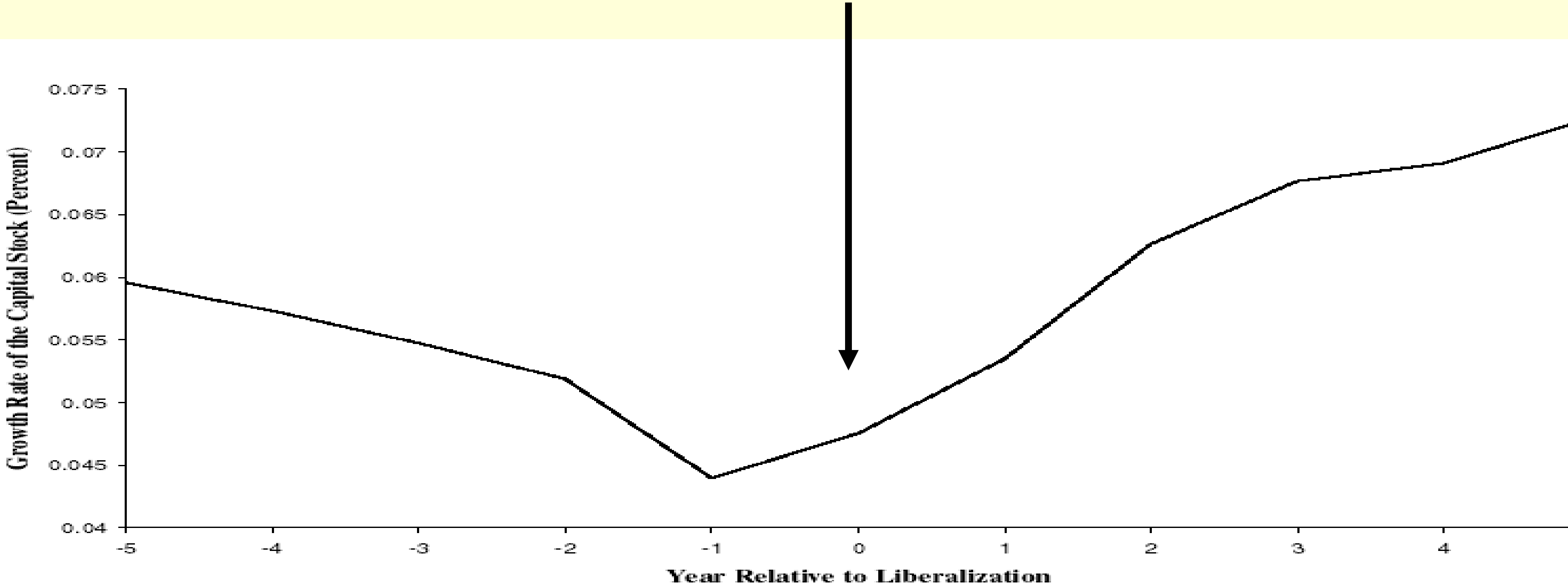


Figure 4. Investment Booms When Countries Liberalize the Capital Account .

Effects on growth when countries open their stock markets.

P.Henry, Nov. 2006

Liberalization occurs in “Year 0”

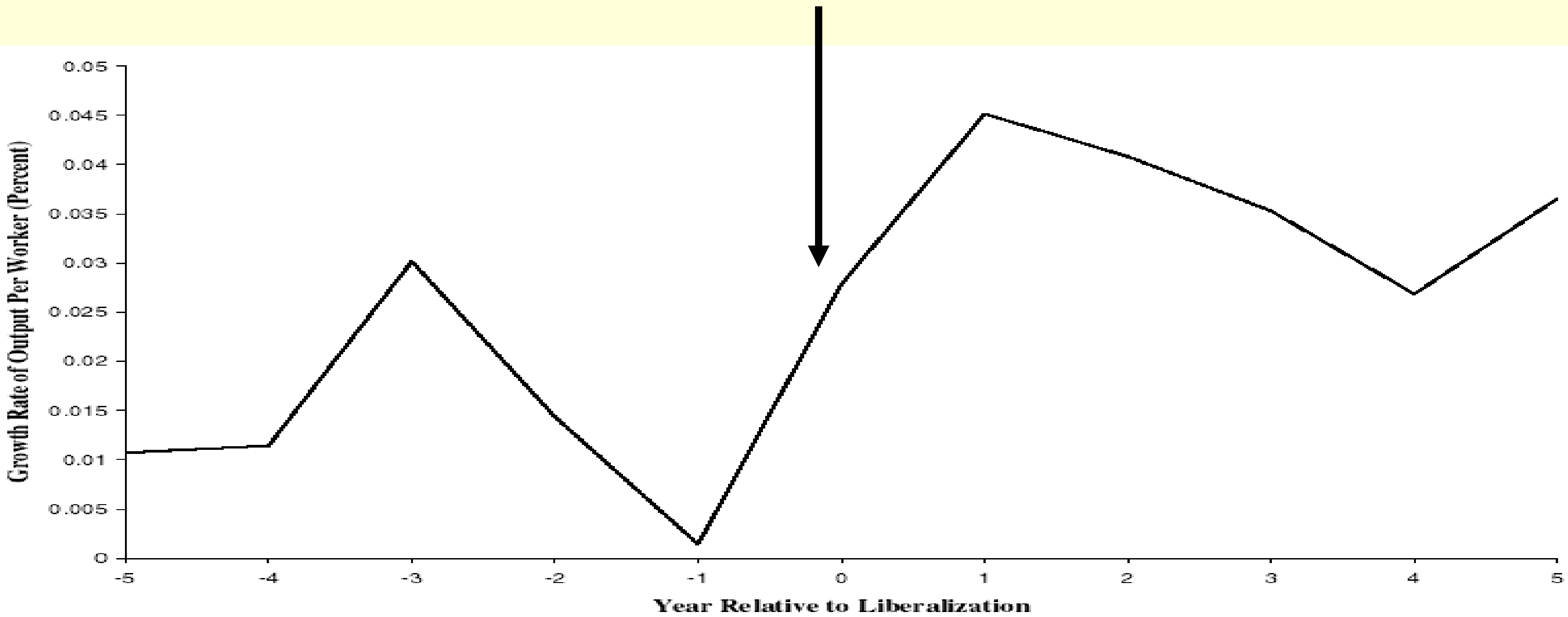


Figure 5. The Growth Rate of Output Per Worker Increases When Countries Liberalize.

Some recent research, continued

One claim is that financial opening lowers volatility [i] and raises growth [ii] only for rich countries, and is more likely to lead to market crashes in lower-income countries [iii].

[i] J. G. Biscarri, S. Edwards, & F. Perez de Gracia, "Stock Market Cycles, Liberalization, and Volatility," NBER WP 9817, 2003.

[ii] M. Klein & G. Olivei, "Capital Account Liberalization, Financial Development, and Economic Growth," NBER WP 7384, 1999; and S. Edwards, "Capital Mobility and Economic Performance: Are Emerging Economies Different?" NBER WP 8076, 2001.

[iii] P. Martin & H. Rey, "Financial Globalization and Emerging Markets: With or Without Crash?" NBER WP 9288, 2002.

But Ranciere, Tornell & Westermann, 2006, "Systemic Crises and Growth," find that countries experiencing occasional financial crises grow faster, on average, than countries with stable financial conditions.

Recent research, continued

A second claim is that capital account liberalization raises growth only in the absence of macroeconomic imbalances, such as overly expansionary monetary and fiscal policy.[i]
They reject the claim that it is the level of development that matters.

[i] C. Arteta, B. Eichengreen, and C. Wyplosz, "When Does Capital Account Liberalization Help More than It Hurts?" NBER WP 8414, 2001.

Recent research, continued

A third important finding is that institutions, such as shareholder protection and accounting standards, determine whether liberalization leads to development of the financial sector, [i]

and in turn to long-run growth.[ii]

[i] M. D. Chinn and H. Ito, "Capital Account Liberalization, Institutions, and Financial Development: Cross-Country Evidence," NBER WP 8967, 2002.

[ii] M. Klein, "Capital Account Openness and the Variety of Growth Experience," NBER WP 9500, 2003.

Recent research, continued

A related finding is that corruption tilts the composition of capital inflows toward the form of banking flows (and away from FDI), and toward $ denomination (vs. denomination in domestic currency), both of which have been associated with crises.

-- S. Wei and Y. Wu,

“Negative Alchemy: Corruption, Composition of Capital Flows, and Currency Crises,” in *Managing Currency Crises in Emerging Markets*, S. Edwards & J. Frankel, eds. (Chicago: University of Chicago Press), 2002.

Recent research, continued

Inadequacies in the financial structures of developing countries probably explain the findings that financial opening in those countries does not produce faster long-run growth as it does in industrial countries

-- E.Prasad, R.Rajan, & A.Subramanian, “Foreign Capital and Economic Growth,” April 2007.

=> liberalization can help if institutions are strong and other fundamentals are favorable, but can hurt if they are not.

Recent research, continued

Another finding is that countries that are open to trade are less likely to experience sudden stops or currency crashes.

G. Calvo, A. Izquierdo & L.F.Mejia, 2003, "On the Empirics of Sudden Stops," IDB WP.

S. Edwards, 2004, "Financial Openness, Sudden Stops and Current Account Reversals", *AER* 94, no.2, May 59-64.

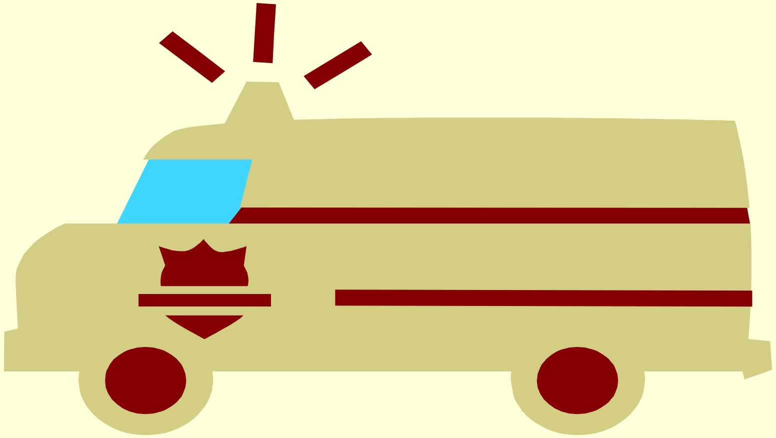
J. Frankel & E. Cavallo, 2004, "Does Openness to Trade Make Countries More Vulnerable to Sudden Stops, or Less? Using Gravity to Establish Causality," NBER WP 10957.

Recent research, continued

All of these findings are consistent with the conventional lesson about the sequencing of reforms: that countries will do better in the development process if they postpone opening the capital account until after other institutional reforms.[i]

[i] e,g., G. Kaminsky and S. Schmukler, "Short-run Pain, Long-run Gain: The Effects of Financial Liberalization," NBER WP 9787, 2003.

10 important policy lessons about emerging market crises can be phrased in terms of the car crash analogy



1. **Sudden stops:** "It's not the speed that kills, it's the sudden stops." – Dornbusch

2. **Superhighways:** Modern financial markets get you where you want to go fast; we are better off with them. But accidents are bigger. – Merton

3. **Is it the road or the driver?**

   Even when multiple countries have accidents in the same stretch of road, –Stiglitz –

   their own policies are also important;

   it's not just determined by the system. – Summers

4. **Contagion** also contributes to multi-car pile-ups.

   => Leave enough following distance (reserves / short term debt)

Car crash analogy, continued

5. **Correlation does not imply causation**:
   That the IMF (doctors) are often found at the scene of fatal accidents (crises) does not mean that they cause them. -- Rogoff

6. **Moral hazard:** G7/IMF bailouts to reduce the impact of a given crisis may in the LR undermine incentives for investors & borrowers to be careful. Like air bags & ambulances. -- Meltzer Report

7. **But** to claim that moral hazard means we should abolish the IMF would be like claiming that drivers would be safer with a spike in the center of the steering wheel column. – Mussa

Car crash analogy, concluded

8. **Reaction time:** How the driver reacts in the short interval between appearance of the hazard and moment of impact (speculative attack) is important. Adjust, rather than procrastinating (by using up reserves & switching to short-term $ debt) – JF
9. **Optimal sequence:** A highway off-ramp should not dump high-speed traffic into the center of a village before streets are paved, intersections regulated, and pedestrians learn not to walk in the streets. So a country with a primitive domestic financial system should not necessarily be opened to the full force of international capital flows before domestic reforms & prudential regulation. – Masood Ahmed
10. **Speed bumps** may have a role (Chile-style taxes on s.t. capital inflow; high reserve requirements on banks' $ liabilities; index debt to commodity prices).