Lecture 12: Benefits of International Financial Integration

• Pros and Cons of Open Financial Markets

• Advantages of financial integration
  • The theory of intertemporal optimization
  • Other advantages

• Do financial markets work as they should?
  • The Lucas paradox
  • Procyclical capital inflows
  • Periodic crises

• Capital Flows to Developing Countries
  • An international debt cycle.
  • Reasons for flows to emerging markets in the 1990s & 2000s.
Advantages of financial opening

• For a successfully-developing country, with high return to domestic capital, investment can be financed more cheaply by borrowing from abroad than out of domestic saving alone.

• Investors in richer countries can earn a higher return on their saving by investing in the emerging market than they could domestically.

• Everyone benefits from the opportunity
  – to smooth disturbances
  – and to diversify away risks.
Further advantages of financial opening in emerging-market countries

• Letting foreign financial institutions into the country improves the efficiency of domestic financial markets. It subjects over-regulated & inefficient domestic institutions – to the harsh discipline of competition and – to the demonstration effect of examples to emulate.

• Governments face the discipline of the international capital markets in the event they make policy mistakes.
Welfare gains from open capital markets

1. Even without intertemporal reallocation of output, consumers are better off (borrowing from abroad to smooth consumption).

2. In addition, firms can borrow abroad to finance investment.
1. Financial opening with fixed output

Assume interest rates in the outside world are closer to 0 than they were at home (the slope of the line is closer to -1.0).

Welfare is higher at point B.

The Intertemporal-Optimization Theory of the Current Account, and Welfare Gains from International Borrowing, continued

2. Financial opening with elastic output

Shift production from Period 0 to 1, and yet consume more in Period 0, thanks to foreign capital flows.

Assume interest rates in the outside world are closer to 0 than they were at home.

Welfare is higher at point C.


**Figure 21.1.A.2** 
Borrowing from Abroad, with Investment

The possibility of physical investment means that there is a transformation frontier between output in the two periods. The country can divert resources to future production at B and borrow more to finance current consumption at C, thereby realizing further welfare gains.
Does this theory work in practice?

Effect when countries open their stock markets to foreign investors on cost of equity capital to domestic firms.

Liberalization occurs in “Year 0.”

Cost of capital falls.

Peter Henry (2007)
“Capital Account Liberalization: Theory, Evidence, and Speculation,”

Figure 3. The Cost of Capital Falls When Countries Liberalize the Capital Account.
Does this theory work in practice? continued

Effect when countries open their stock markets to foreign investors on investment.

Rate of capital formation rises.

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

Peter Henry (2007)
Does this theory work in practice?

continued

Norway discovered North Sea oil in 1970s. It temporarily ran a large CA deficit,

- to finance investment (while the oil fields were being developed)
- & to finance consumption (as was rational, since Norwegians knew they would be richer in the future).

Subsequently, Norway ran big CA surpluses, > 10% GDP 2000-14.
Indications that financial markets do not always work so well in practice

• Generally, capital flows have:
  
  ➢ *not* on average gone from rich (high K/L) to poor (low K/L) countries – The “Lucas paradox;”

  ➢ often been procyclical, rather than countercyclical.
Indications that financial markets do not always work well (continued)

• Crises => Financial markets work imperfectly. Sudden stops:
  ➢ the 1982 international debt crisis;
  ➢ 1992-93 crisis in the European ERM;
  ➢ 1994 Mexico;
  ➢ 1997 East Asia; 1998 Russia; 2000 Turkey; 2001 Argentina
  ➢ 2007-09 Global Financial Crisis; 2008 Iceland;
  ➢ 2010- Euro crisis: Greece, Ireland, Portugal, Spain.

• It can be difficult to argue that investors punish countries when and only when governments follow bad policies:
  ➢ Large inflows often give way suddenly to large outflows, with little news appearing in between to explain the change in sentiment.
  ➢ 2\textsuperscript{nd}, contagion sometimes spreads to where fundamentals are strong.
  ➢ Recessions hitting emerging markets in such crises have been so big, that the system does not seem to be working optimally.
3 waves of capital flows to Emerging Markets:

- late 1970s, ended in the intl. debt crisis of 1982-89;
- 1990-97, ended in East Asia crisis of 1997-98;
- and 2003-2008, ended in GFC of 2008-09?
Causes of renewed capital flows to emerging market countries in early 1990s, 2003-13

“Pull” factors (domestic): Economic reforms in the South

1. Economic liberalization => pro-market environment
2. Privatization => assets for sale
3. Monetary stabilization => higher returns
4. Removal of capital controls => open to inflows

“Push” factors (external): Global financial environment

1. More of Northern portfolios in mutual funds
2. Low interest rates in the North

1st boom (recycling petro-dollars)

stop (international debt crisis)

2nd boom (emerging markets)

stop (Asia crisis)

3rd boom (carry trade & BRICs)

Figure 1. Current account balance (% of GDP)

José De Gregorio
Capital Flows and Capital Account Management
IMF
Rethinking Macro Policy II: First Steps and Early Lessons
April 16-17, 2013

Source: International Monetary Fund, World Economic Outlook. Latin America and developing Asia are simple averages across countries. Latin America: Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela. Developing Asia: China, India, Indonesia, Korea, Malaysia, Philippines and Thailand. Emerging markets (EME) corresponds to the IMF’s weighted average definition.
EM countries used post-2003 inflows to build international reserves


Figure 15: Emerging Market International Reserves

Source: IMF IFS, April 2014, Deutsche Bank Research
Appendix 1:

More on opening equity markets to foreign investment.

Effects when countries open their stock markets to foreign investors on cost of capital, investment, & growth. Liberalization occurs in “Year 0”
(Peter Henry, Nov. 2006)
Effect when countries open their stock markets to foreign investors on growth.

Figure 5. The Growth Rate of Output Per Worker Increases When Countries Liberalize.
Appendix 2: Three cycles of capital flows to EMs

1. **1975-81** -- Recycling of petrodollars, via bank loans

   **1982**, Aug. -- **International debt crisis** starts in Mexico and spreads

   **1982-89** -- The “lost decade” in Latin America.

2. **1990-96** -- New record capital flows to emerging markets

   **1994**, Dec. -- Mexican peso crisis

   **1997**, July -- Thailand forced to devalue & seek IMF assistance => beginning of **East Asia crisis** (Indonesia, Malaysia, Korea...)


   **2001**, Feb. -- Turkey abandons exchange rate target


3. **2003-08** -- New capital flows into EM countries, incl. BRICs...

   **2008-09** -- Global Financial. Crisis;

   **2010-12** -- Euro crisis: Greece, Ireland, Portugal...
Three booms in capital flows to developing countries

1\textsuperscript{st} boom (recycling petro-dollars)

2\textsuperscript{nd} boom (emerging markets)

3\textsuperscript{rd} boom (carry trade / BRICs)

1\textsuperscript{st} boom (international debt crisis)

stop (Asia crisis)
Capital flowed to Asia in the 1990s, and again 2003-12.

(b) Asia

- 2nd boom (emerging markets)
- 3rd boom (carry trade & BRICs)

Stop (Asia crisis)
Capital flowed to Latin America in the 1990s, and again 2004-12

Figure 3. Gross capital inflows (billions of U.S. dollars)

(a) Latin America

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