The costs and benefits of capital market integration

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Globalization of financial markets and the "Washington Consensus"

1. Macroeconomic discipline
   – Fiscal discipline, reprioritize gov't spending, tax reform
2. Foster market economy
   – Liberalize interest rates, liberalize banking system, deregulation, privatization, encourage securitization, competitive exchange rate
3. Openness to global economy
   – Trade liberalization
   – Capital account liberalization: lift restrictions on foreign control, allow foreigners to enter equity market; greater participation of foreign banks

Lessons from the past

1. Washington Consensus (early 1990s)
   – Reforms to “get prices right”
   – Large increase in capital flows
   – Followed by a sequence of financial crises

2. Washington Consensus II (mid-2000s)
   – Market prices not enough; need to “get institutions right”
   – Central role for government policy

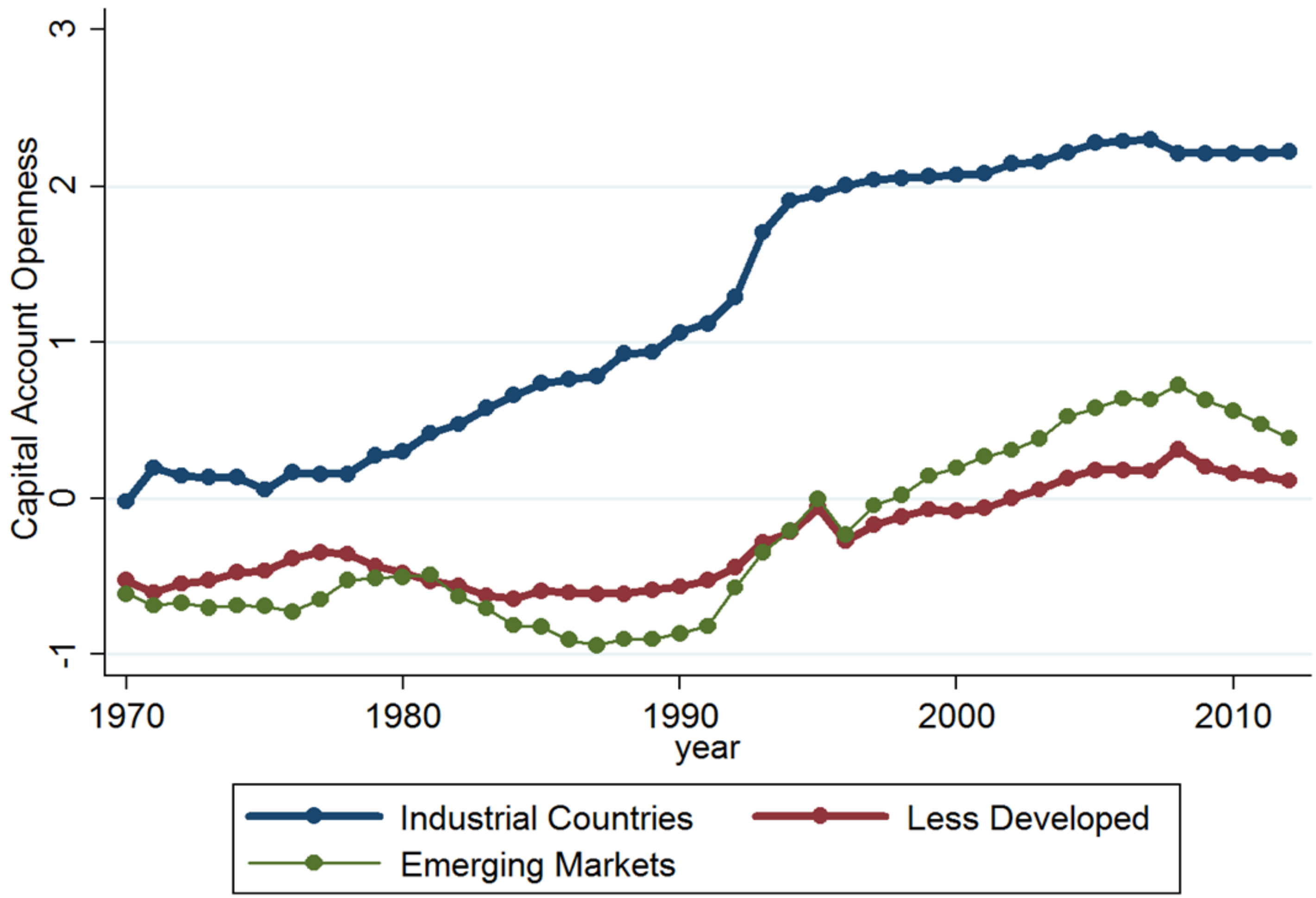
Potential benefits from capital market integration

- Efficiency gains
  - Stimulate capital flow from capital-rich to capital-poor and reduce the cost of capital
  - Increase efficiency of financial sector, through higher competition

- Increase stability
  - Insurance against national income shocks (i.e. consumption smoothing)
  - Increase opportunities for diversification and management of risk
  - "market discipline" – reinforce commitment to good economic policies
  - Promotes greater information sharing

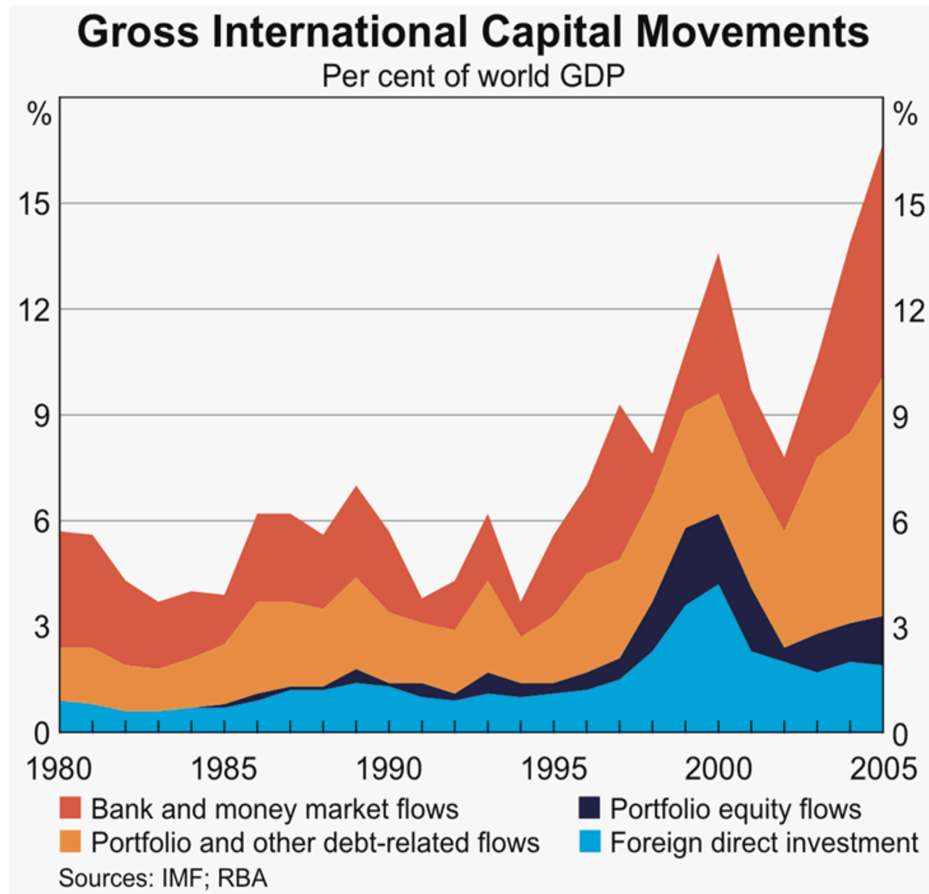
- Faster economic growth
  - Mobilizes savings, providing higher rate of return
  - Faster growth in the short-run as countries "catch-up" to the frontier; convergence in income levels
  - In the longer-run, technological spillovers through cross-border investment
  - Indirect channel through better policies and signaling of commitment to those policies
    - Kose, et. Al. This could be the largest contributor to growth effect

What did we see?...
Falling barriers to capital mobility

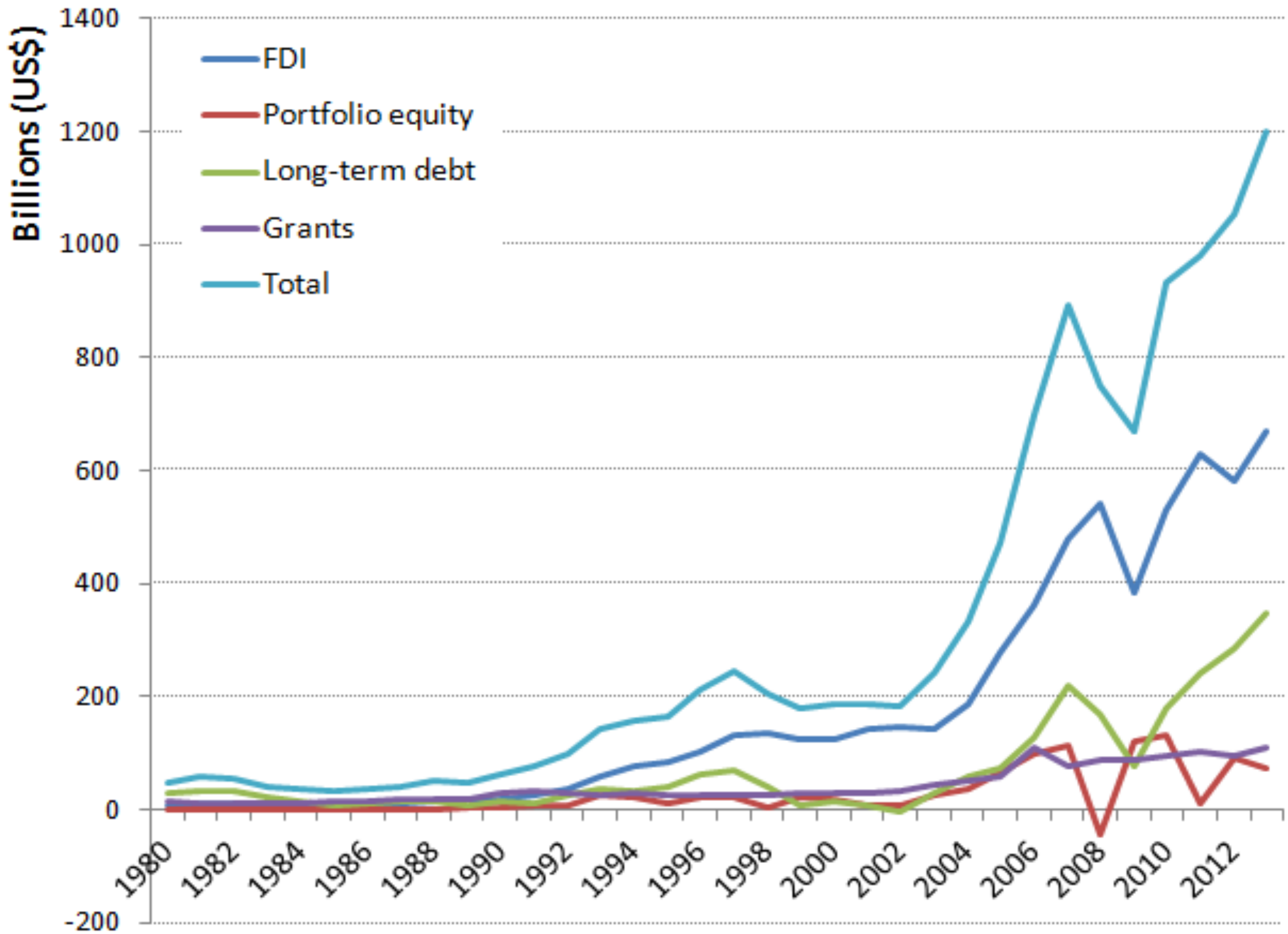


Source: Chinn and Ito (2006). Data updated to 2013.

Sharp increase in cross-border capital flows

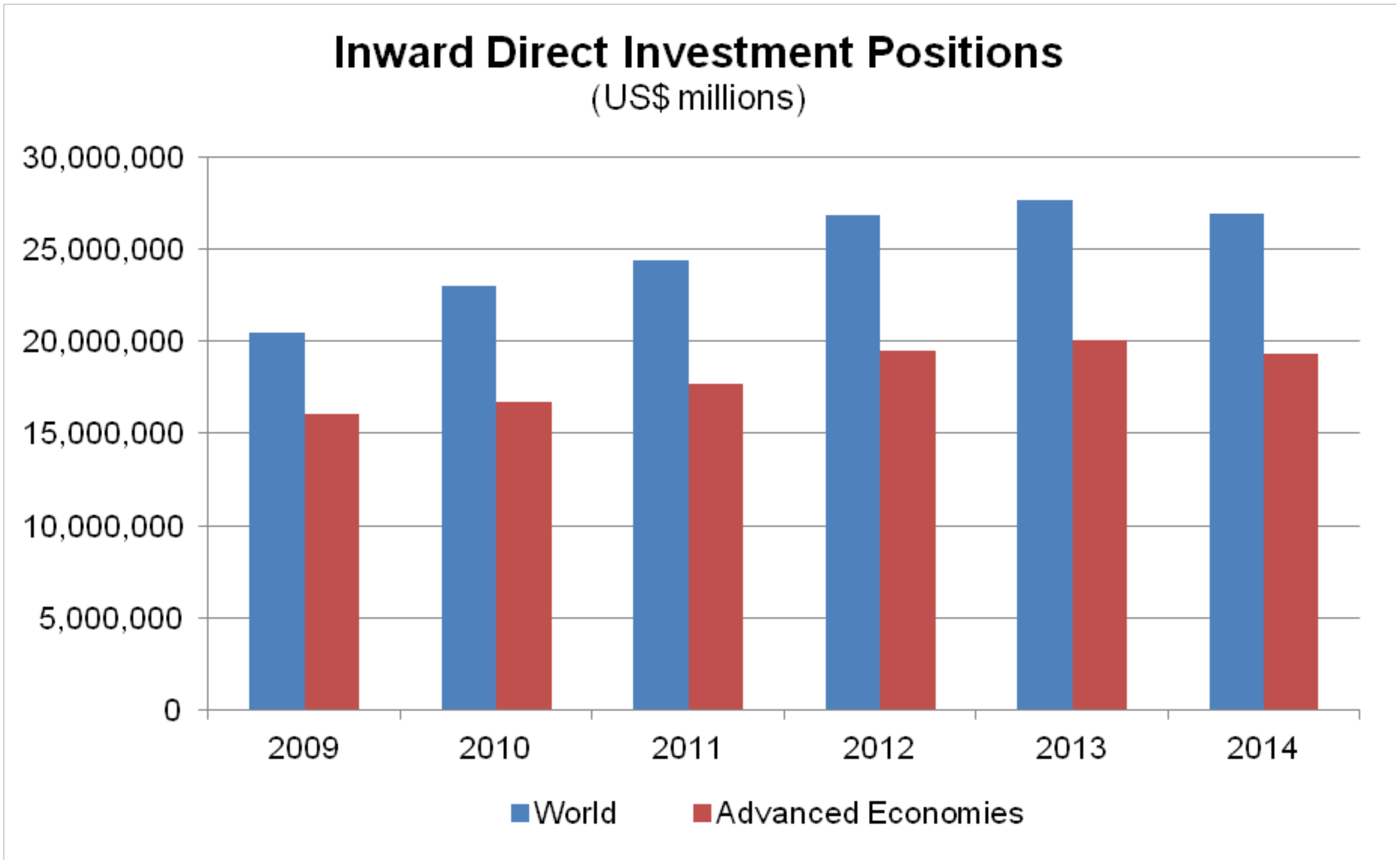


Increase in flows to developing countries



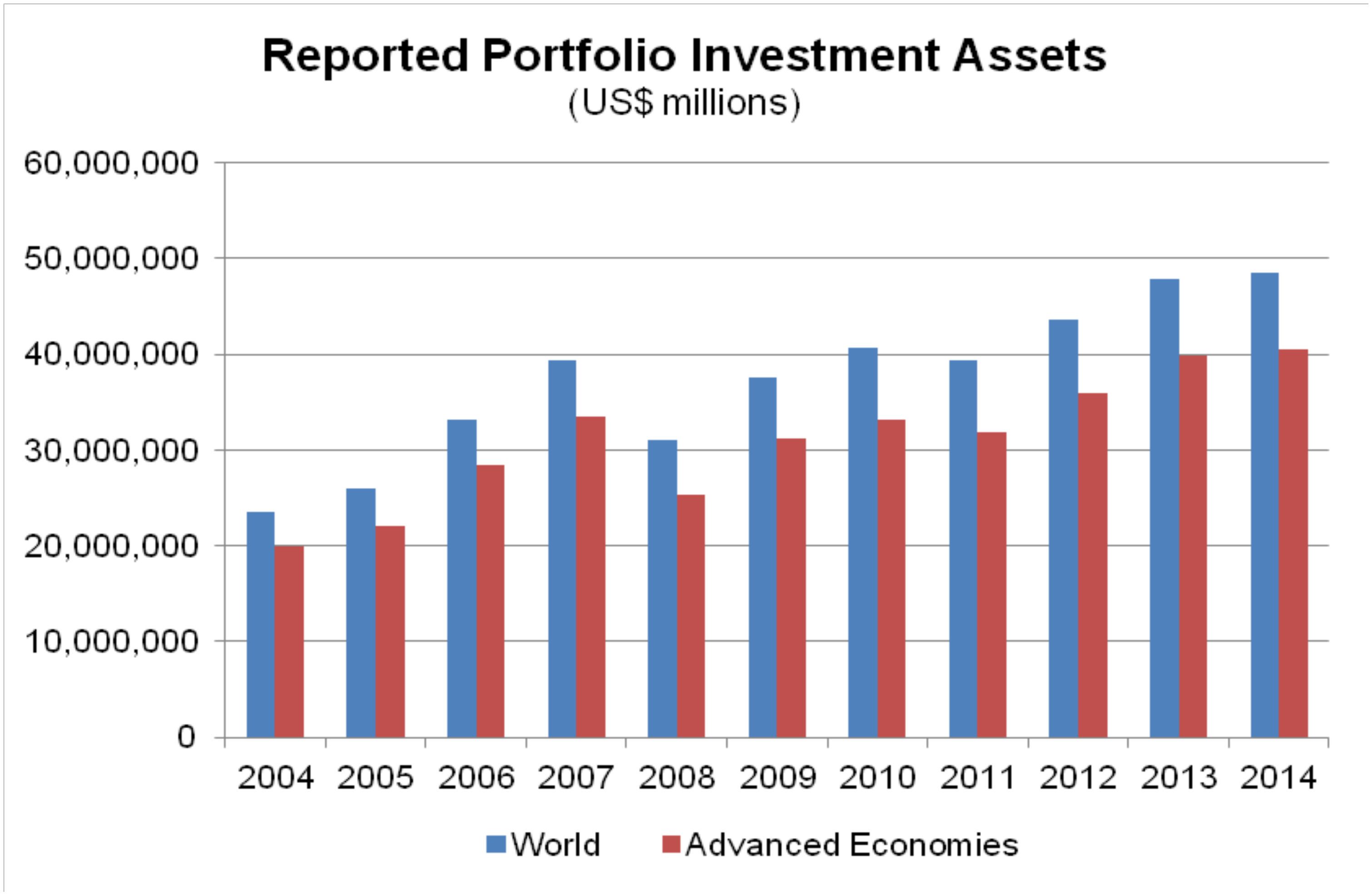
Source: World Development Indicators.

Though capital markets still dominated by flows between industrialized countries… (1)



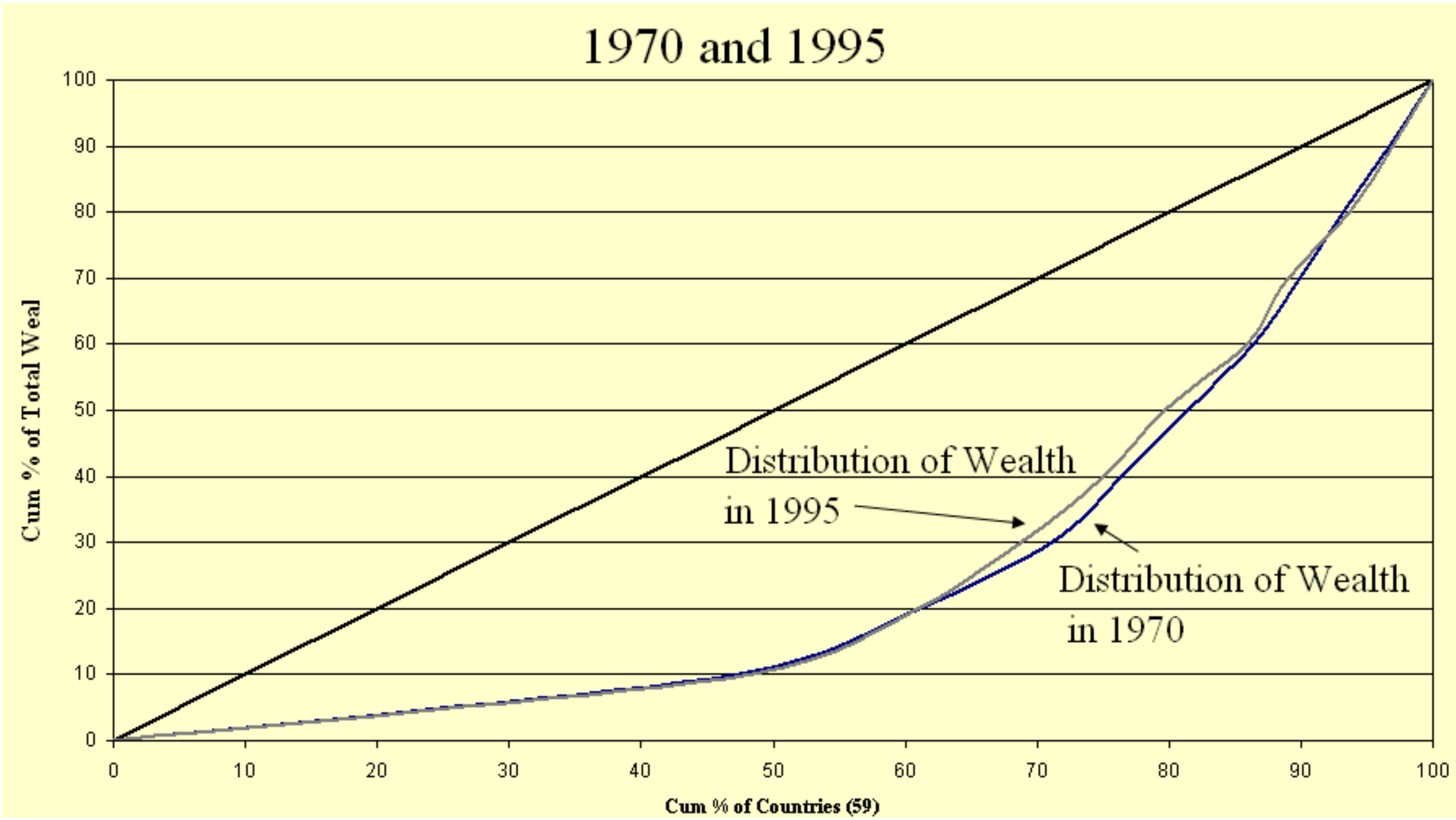
Source: Coordinated Direct Investment Survey (CDIS)

Though capital markets still dominated by flows between industrialized countries… (2)

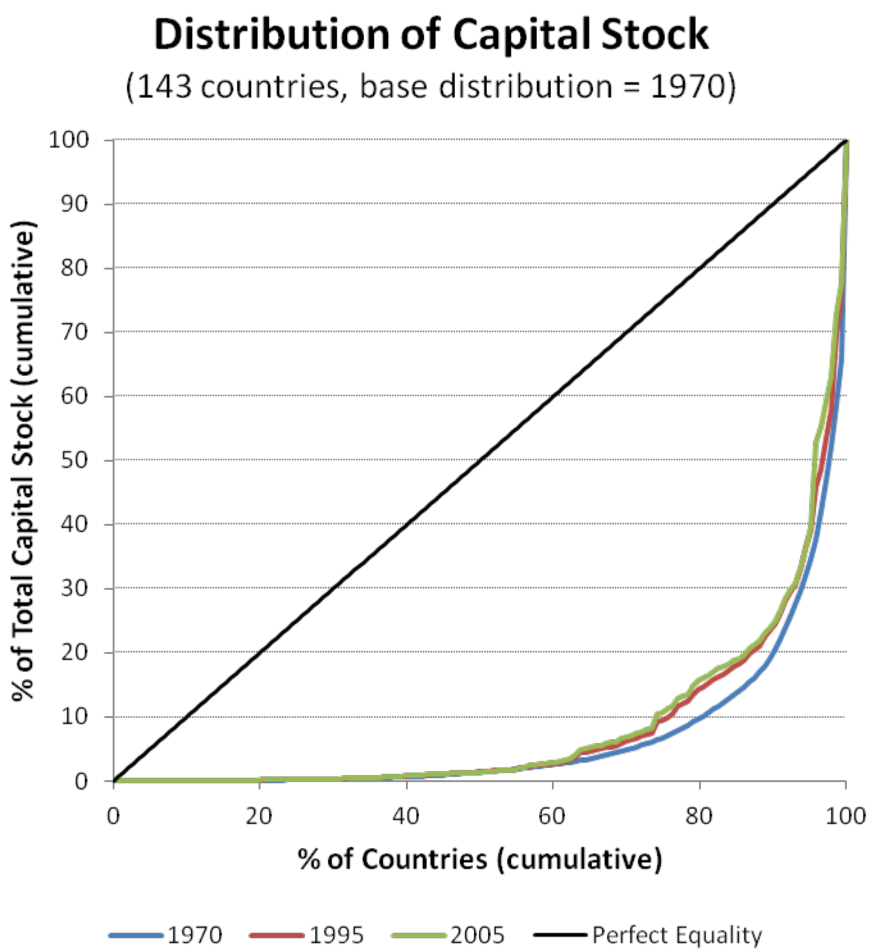


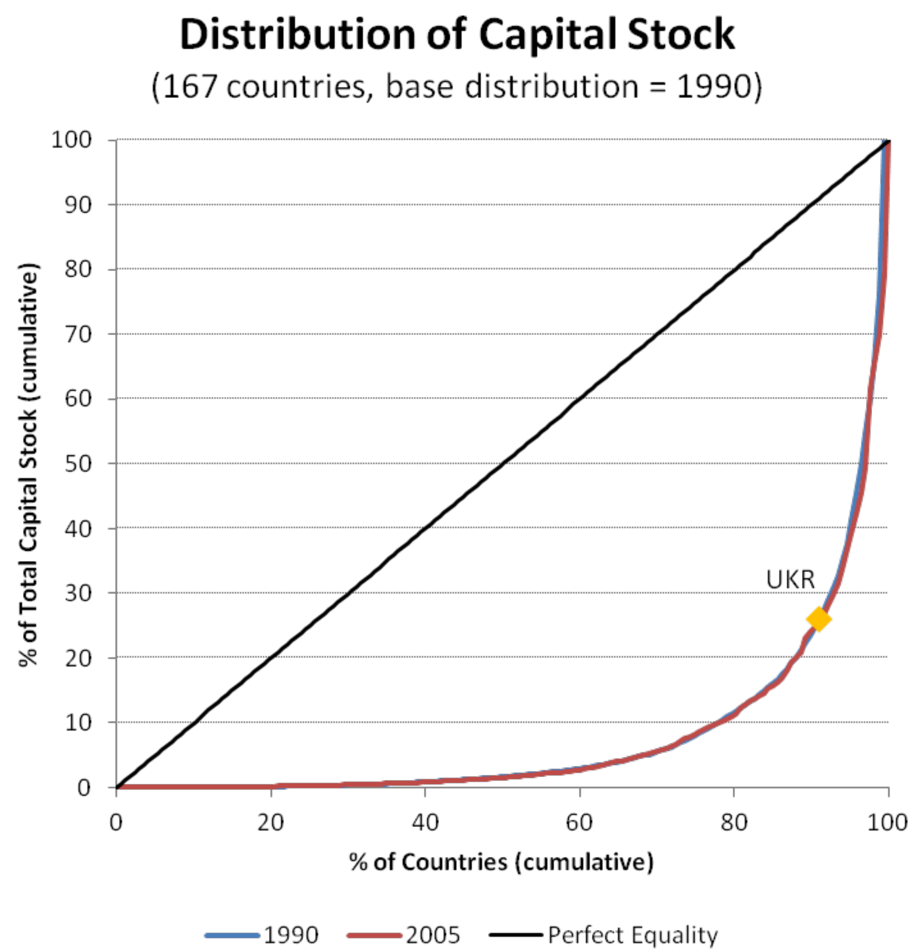
Source: Coordinated Portfolio Investment Survey (CPIS)

Capital markets also did not redistribute wealth…



…or the capital stock.





Source: Own calculations using PWT data

Liberalization prompted capital flows but capital markets did not deliver on all promises

- Reduced home bias in investment portfolios
- More flows to emerging markets
- Boom in emerging stock markets

But…

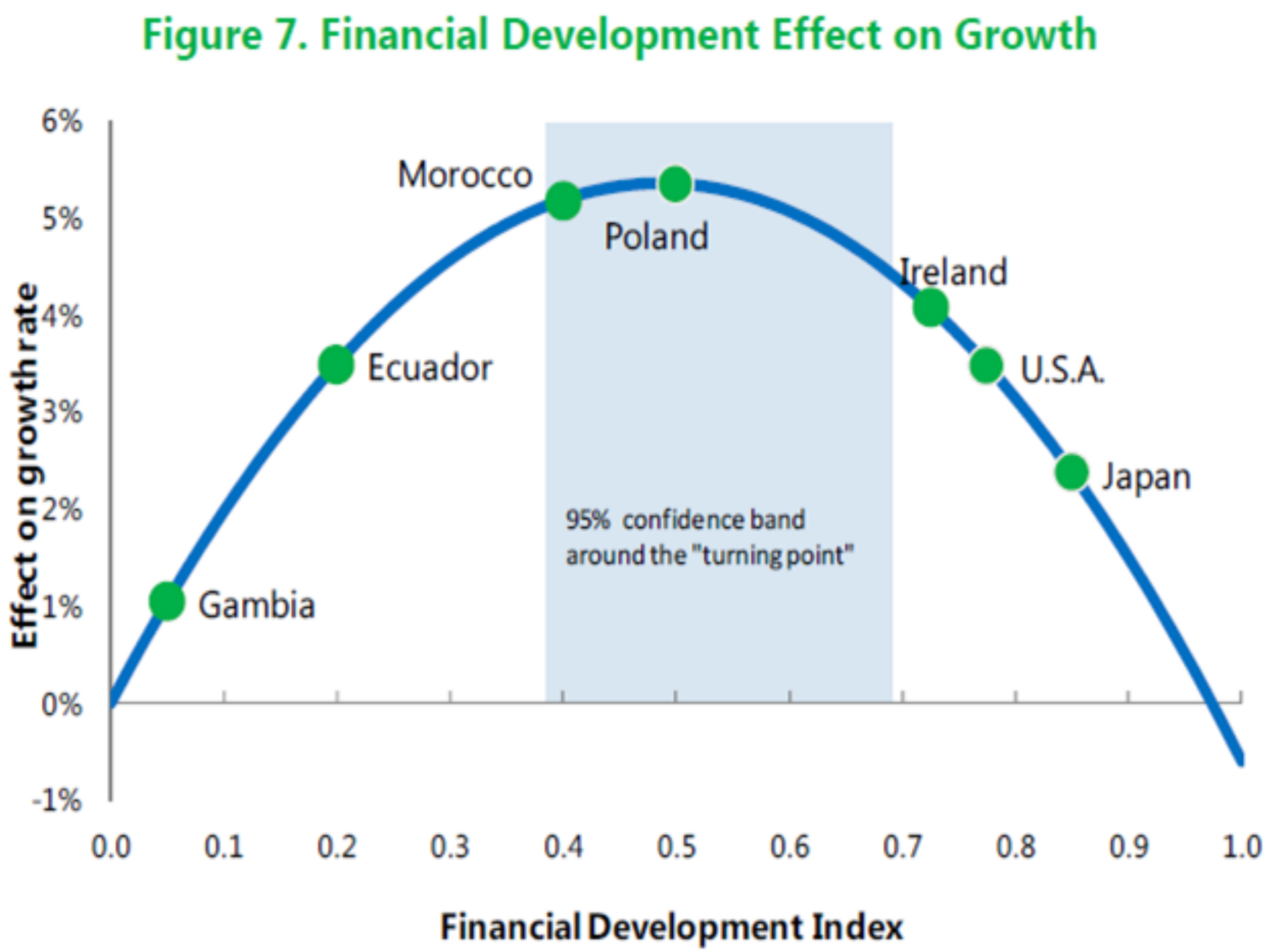
A large body of empirical evidence suggests that capital markets did not deliver on promises (1)

- Distribution of capital
  - Within countries (firm level evidence)
  - Across countries

- Limited ability to smooth consumption
  - Capital flows to emerging markets are procyclical, which amplifies volatility
  - Standard deviation of consumption relative to income remains high

Capital market integration and growth?

- Evidence of causal effect of capital market integration on growth has been hard to identify (Kose et. al.)
  - On average, emerging economies that have liberalized their capital markets have shown higher growth rates, but the effect vanishes after controlling for other factors
  - "Collateral" benefits of integration
- Trade-off between growth and stability (Sahay et al, 2015):
  - The pace of financial development matters for the impact of capital market openness on growth
  - Only a small set of financial regulation matter (and these have positive effect on both growth and stability)



Source: Sahay et al (2015)

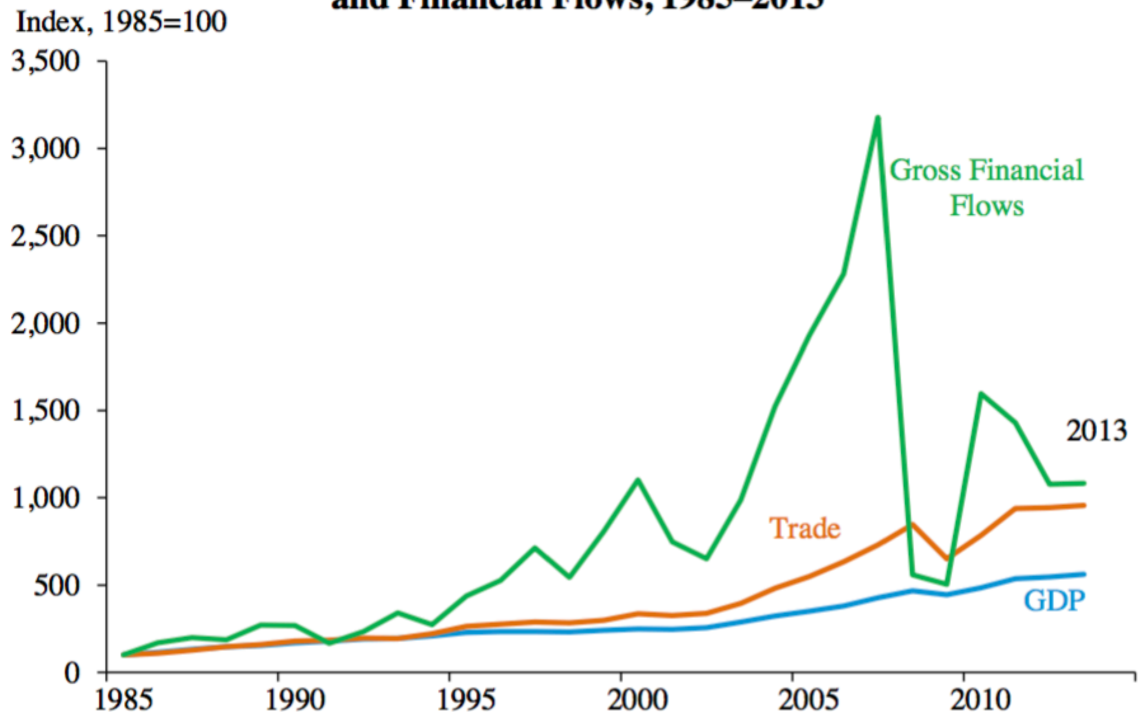
Link between financial market openness and crises

- Sudden stops
- Currency crises
- Contagion
- Lack of lender of last resort…

- … How has our perspective changed in the aftermath of the global financial crisis?

Figure 7-7

Growth of Global GDP, Trade in Goods and Services, and Financial Flows, 1985–2013

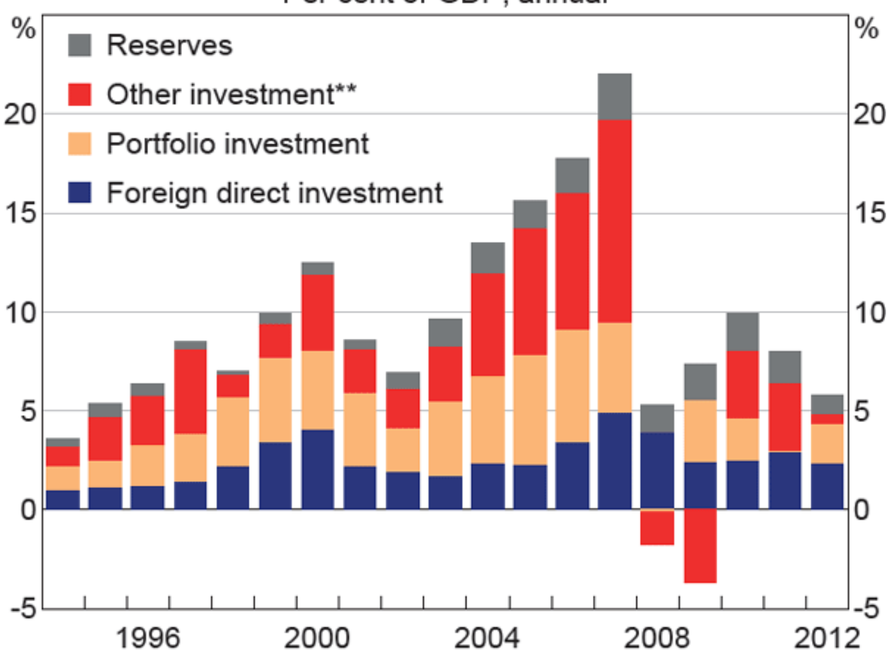


Note: All data are in nominal U.S. dollars. Global trade is defined as the average of global exports and imports of goods and services. Gross global financial flows are defined as the sum of direct investment, portfolio investment, and foreign exchange reserves. Values are obtained by averaging inflows and outflows to account for measurement error.
Source: UNCTAD; IMF, International Financial Statistics.

Large global contraction in "other investment" – i.e. banks

Global Capital Flows*

Per cent of GDP, annual



* Gross capital outflows; excluding financial derivatives; 2012 data are latest available

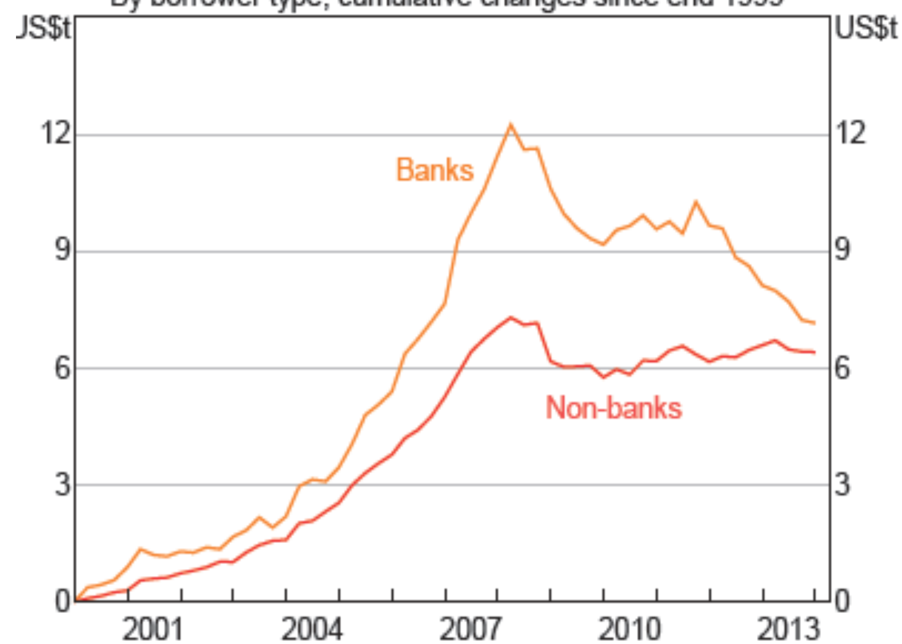
** Includes flows related to international banking transactions

Source: IMF

Graph 2

Cross-border Bank Lending

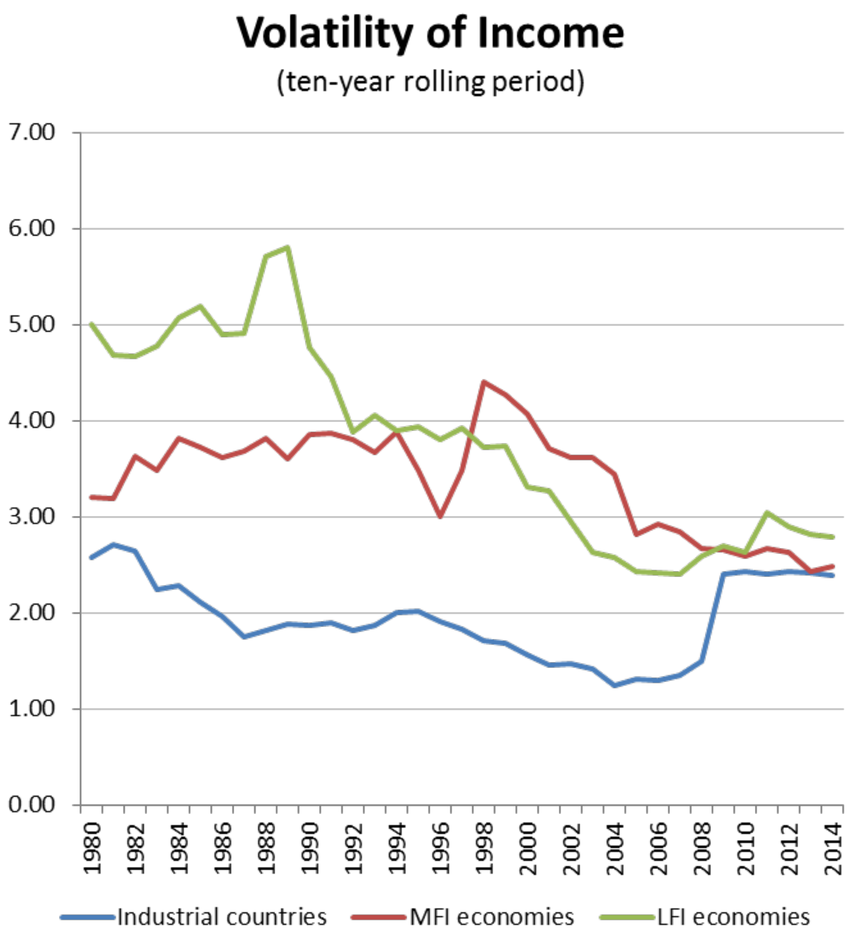
By borrower type, cumulative changes since end 1999*

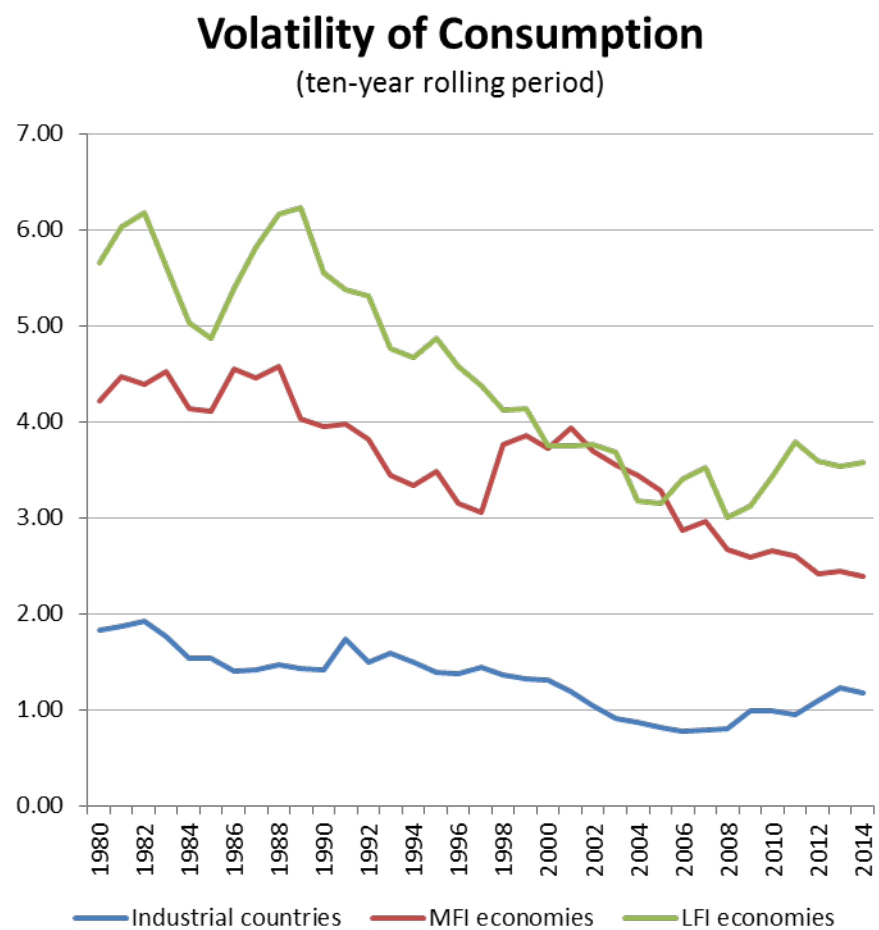


* Adjusted for exchange rate movements and series breaks by the BIS

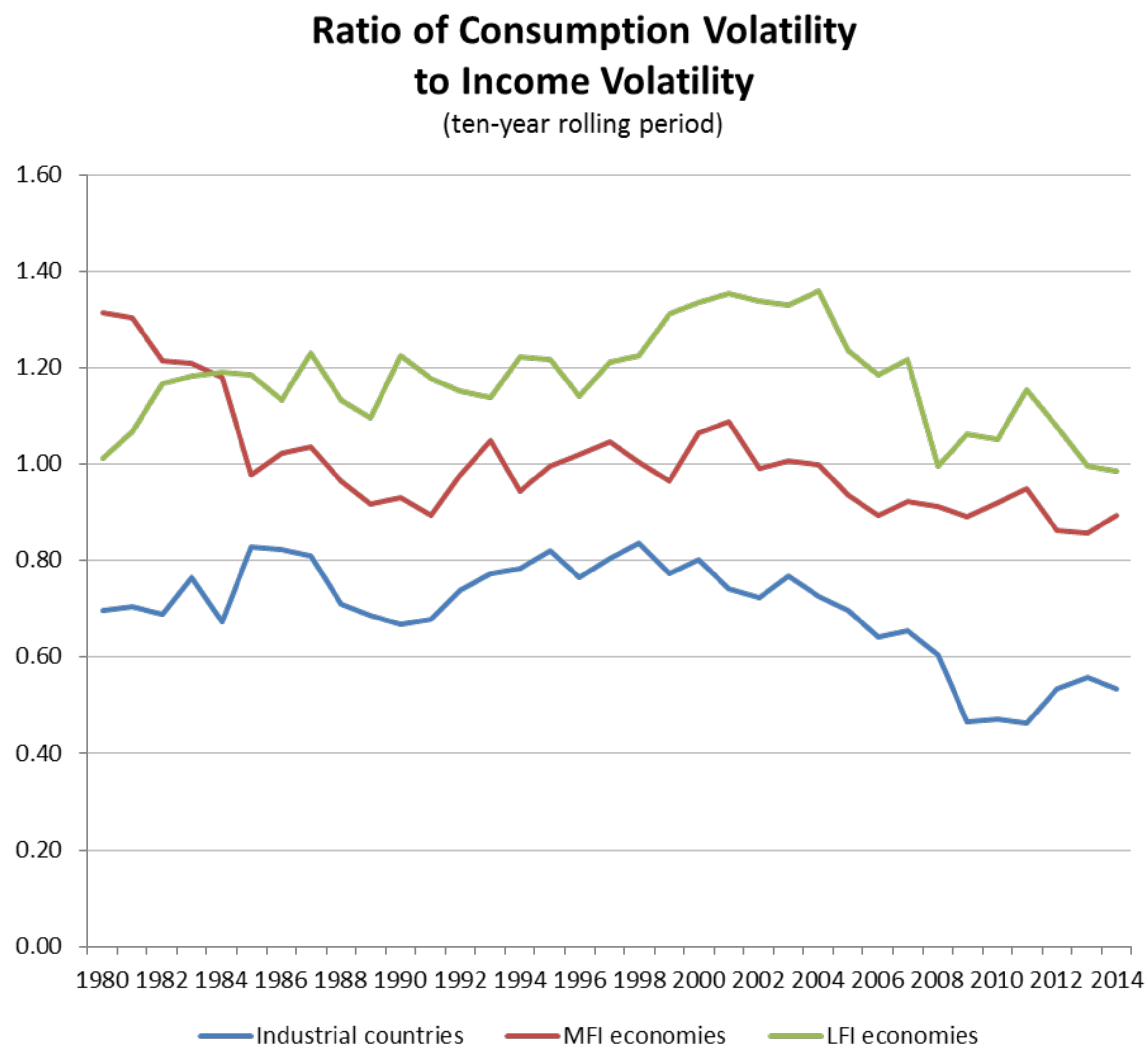
Source: BIS Locational Statistics

Impact of GFC on risk sharing





Source: Own estimates, based on Prasad et al (2007). Data from World Development Indicators.



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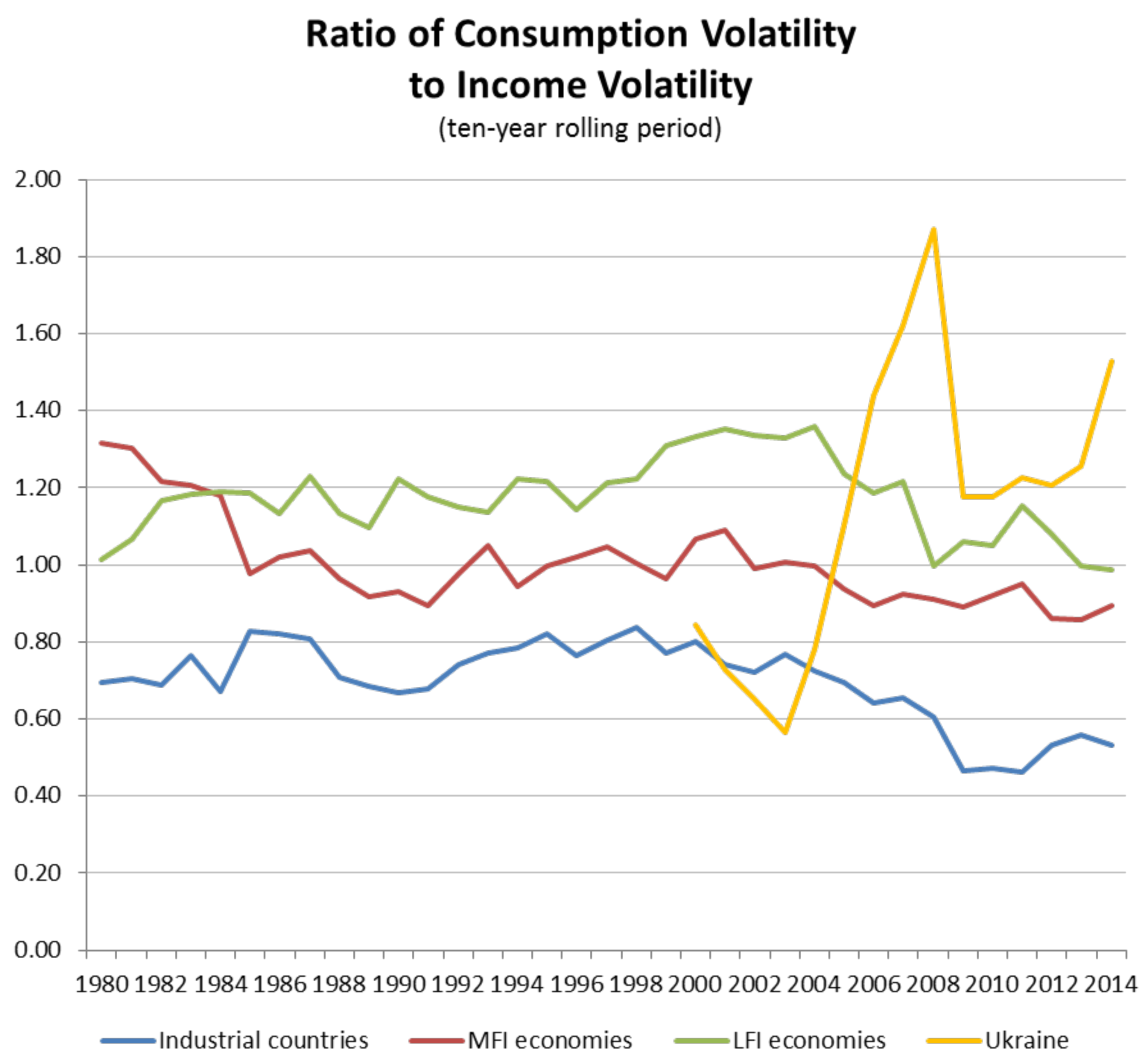


Source: Own estimates, based on Prasad et al (2007). Data from World Development Indicators.

Looking for risk in the wrong places?

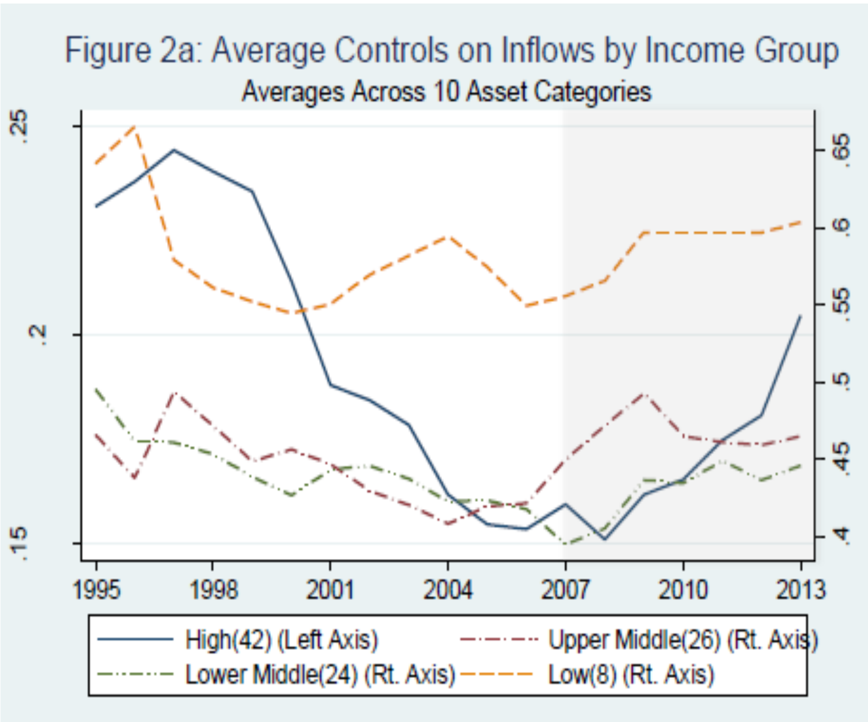
- Focus on aggregate capital flows; not much emphasis on composition of flows, in particular lack of focus on debt and bank loans
- Some focus on exchange rate exposure, but in general more flexible exchange rates with open capital markets presumed most efficient
- Emerging market crises provided some clues that weaknesses in financial regulations could be important, but not believed to be an issue in advanced economies

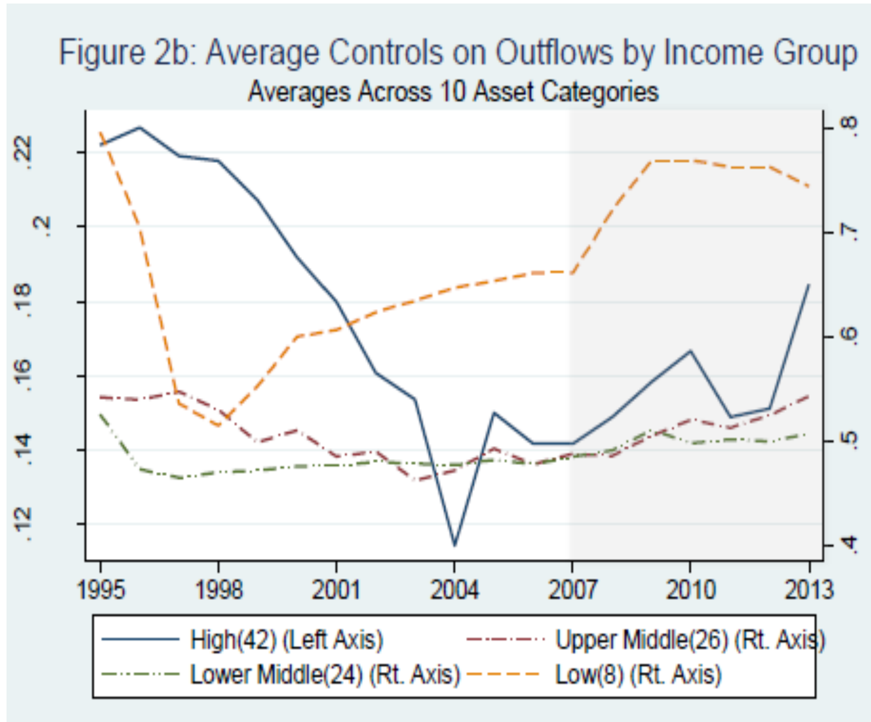
The financial crisis has forced us to review our thinking on capital market integration.

- Role of financial sector: clues that this was a source of instability in emerging market crises, but few were concerned about such risks in advanced economies
- Importance of financial regulation; much remains to be done in the sphere of global cooperation
- Role of debt:
  - Debt is not state-contingent. Provides useful liquidity function in good times. Reliance on debt can create severe constraints & bottlenecks in bad times.
- Efficiency of the financial sector: how much finance is really needed to support economic growth?
- Central role of policy
  - Policy missteps proved very costly – e.g. austerity, delayed monetary policy reaction

Capital controls

- Under the Washington Consensus, controls were taboo. Now considered part of the toolkit available to policymakers.





Source: Fernandez et al (2015). Shaded area added.
Note: A higher value of the capital controls index indicates stronger capital controls

Rethinking the role of capital controls

- Potential benefits:
  - Controls on inflows may protect the economy from speculative flows, limit growth of "bubbles"
  - Controls on outflows can mitigate effect of capital flow reversals or sudden stops
  - Manage the composition and maturity of flows
  - Provide a shield behind which the financial sector can be reformed and strengthened

Rethinking the role of capital controls

- Potential costs:
  - The barrier may decrease the efficiency of the financial sector; removes pressures to liberalize
  - Economic agents will adapt to the presence of controls; once in place may be politically difficult to remove
  - Lots of new exciting research evaluating the conditions under which capital controls, while second best, can improve economic outcomes
  - Difficult to generalize – results depend on the specifics of the particular policy environment