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Financial development and the instability of open economies [☆]

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Abstract

This paper introduces a framework for analyzing the role of financial factors as a source of instability in small open economies. Our basic model is a dynamic open economy model with a tradeable good produced with capital and a country-specific factor. We also assume that firms face credit constraints, with the constraint being tighter at a lower level of financial development. A basic implication of this model is that economies at an intermediate level of financial development are more unstable than either very developed or very underdeveloped economies. This is true both in the sense that temporary shocks have large and persistent effects and also in the sense that these economies can exhibit cycles. Thus, countries that are going through a phase of financial development may become more unstable in the short run. Similarly, full capital account liberalization may destabilize the economy in economies at an

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intermediate level of financial development: phases of growth with capital inflows are followed by collapse with capital outflows. On the other hand, foreign direct investment does not destabilize.

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1. Introduction

This paper introduces a framework for analyzing the role of financial factors as a source of instability in small open economies. Our basic model is a dynamic open economy model with a tradeable good produced with internationally mobile capital and a country-specific factor. Moreover, firms face financial constraints: the amount they can borrow is limited to μ times the amount of their current level of investible funds.¹ A high μ then represents an effective and developed financial sector while a low μ represents an underdeveloped one.

Our model can provide some answers to a number of important and rather basic questions. First, we show that it is economies at an intermediate level of financial development—rather than the very developed or underdeveloped—that are the most unstable. This is true both in the sense that temporary shocks will have large and persistent effects and also in the sense that these economies can exhibit stable limit cycles. Thus, countries going through a phase of financial development may become more unstable in the short run.

Second, the model allows us to examine the effects of financial liberalization on the stability of the macroeconomy. Once again it turns out that the interesting economies are the ones at an intermediate level of financial development. In these economies, full financial liberalization (i.e., opening the domestic market to foreign capital flows) may actually destabilize, inducing chronic phases of growth with capital inflows followed by collapse with capital flight. On the other hand, foreign direct investment never destabilizes since foreign direct investors come in with their own credit—their ability to invest is unrelated to the state of the domestic economy. Overall, this suggests that economies at an intermediate stage of financial development should consider carefully how they liberalize their capital account. Allowing foreign direct investment while initially restricting portfolio investment may sometimes be a reasonable approach.

Third, our model allows us to assess the macroeconomic effects of specific shocks to the financial sector such as overlending by banks (leading to a phase of bank

¹The fact that firm level cash-flow is an important determinant of investment is now widely recognized even in the context of economies like the U.S. which have excellent financial markets. (e.g., see Hubbard (1998) or Bernanke et al., 1999).

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