



Financial integration, nominal rigidity, and monetary policy

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ABSTRACT

This paper shows that financial integration may reduce welfare in the presence of nominal price rigidity. From a policy perspective, the model implies that developing countries that are experiencing financial integration may attempt to alleviate the welfare cost of integration by stabilizing the exchange rate. Hence, this paper provides a novel explanation for “fear of floating”. For industrial countries that have the ability to operate efficient inflation targeting policy, financial integration is always beneficial. Thus, the different monetary regimes implemented in the industrial vs. the developing countries explain their divergent degrees of financial integration since the early 1990s.

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1. Introduction

Cross-country gross asset positions have increased dramatically in the past few decades. According to Lane and Milesi-Ferretti (2007), the sum of foreign assets and liabilities to GDP ratio (IFIGDP) has increased from approximately 45% to over 300% in industrial countries and from about 40% to nearly 150% in developing countries between 1970 and 2004.¹ As shown in Fig. 1, the increase in cross-border asset trade was fairly stable during the 1970s and the 1980s. The two country groups had very similar trends in international financial integration up to the early 1990s. Since then, an *acceleration* of cross-border asset trade has taken place in industrial countries, while developing countries have failed to pick up the pace. The main goal of this paper is to explain the observed evolution of financial integration. Obviously, the early 1990s is a decisive period to focus on.

In 1990, New Zealand adopted the first inflation targeting regime, quickly followed by other developed countries. In line with Goodfriend (2003), Ito and Mishkin (2004), Rose (2007), and Wyplosz (2006), all the 23 industrial countries classified by Lane and Milesi-Ferretti (2007) target inflation either explicitly or implicitly. In other words, the entire industrial country group has essentially adopted the same monetary strategy since the early 1990s, which is exactly the time when the acceleration in cross-border asset trade began. However, as stated by the De Facto Classification of Exchange Rate Regime and Monetary Policy Framework (IMF, 2006), only 19 out of the 155 developing countries classified by Lane and Milesi-Ferretti (2007) have adopted

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¹ FIGDP has been widely used as a measure of de facto financial integration. The industrial countries include Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, and United States.

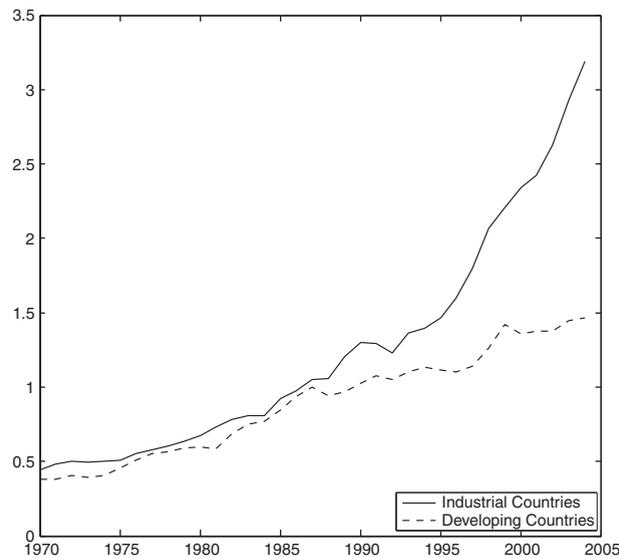


Fig. 1. Sum of foreign assets and liabilities to GDP ratio: industrial vs. developing countries, 1970–2004. Author's calculation is based on the updated and extended version of dataset constructed by Lane and Milesi-Ferretti (2007).

an inflation targeting regime.² Most of these countries started targeting inflation after the 1997 Asian Financial Crisis. The majority of developing countries still use exchange rate as the nominal anchor when conducting monetary policy.

Overall the industrial country group and the developing country group participate at very different levels in the international financial markets. The two groups also adopt very different monetary strategies. This gives rise to the following questions: (1) Does the monetary policy regime have an impact on the desirability of financial integration? (2) Is there a welfare case for fixed exchange rate regime as financial openness increases?

To answer these questions, I study the interaction between financial integration and monetary policy in a simple two-country general equilibrium model with endogenous portfolio choices and nominal price rigidity. Households choose optimal portfolio positions from familiar assets such as bonds and equities. Conditional on the range of assets and other aspects of the model, the financial market structure can be divided into three types: financial autarky, incomplete financial market, and complete financial market. By contrasting the financial autarky with the complete and the incomplete financial market, this paper unifies the analysis of full and partial financial integration. To facilitate the comparison of my results with those of the standard new open-economy models, I assume that there exists a production subsidy. Consequently, I abstract from distortion caused by monopolistic competition and focus on two types of frictions, namely imperfect international consumption risk sharing and nominal price rigidity. To complete the model, I specify the monetary policy as a simple money supply rule. I then base the comparison of several monetary regimes, such as money targeting, unilateral peg, bilateral peg, and producer price targeting, on the welfare of each country.

The monetary policy is 'active' or 'passive' depending on the responsiveness of monetary authorities to the stochastic shocks in the economy. Out of the four sets of monetary regimes considered in this paper, only the money targeting regime is passive because both home and foreign monetary authorities keep their money supply constant. All the other regimes are active due to the presence of active involvement of the monetary authorities. Notice that both the money targeting and the producer price targeting regime have flexible exchange rate. To distinguish the two, the money targeting regime can be described as a passive floating exchange rate regime, while the producer price targeting regime represents a form of active floating exchange rate regime.

The most striking result of this paper is that financial integration reduces welfare under the money targeting regime. The reason is that financial integration leads to an increase in the terms of trade volatility, which is already excessive from a welfare standpoint in financial autarky. Pegging exchange rate eliminates the excessive terms of trade adjustment. Hence, fixed exchange rate regimes become more appealing than the passive floating exchange rate regime to a country that has some access to the international financial market. Nonetheless, targeting producer price removes the sticky price distortion and replicates the flexible price equilibrium. In this case, although financial integration still results in a higher volatility in terms of trade, the terms of trade volatility is below optimal in financial autarky. In fact, this active floating exchange rate regime, combined with perfect international risk sharing, brings the economy to the first-best, which is consistent with the well known result in the literature that it is optimal to stabilize producer price in a benchmark complete market open economy model without local currency pricing, cost-push or government expenditure shocks (e.g., see Benigno & Benigno, 2003, Clarida, Gali, & Gertler, 2001; Clarida, Gali, & Gertler, 2002, and Gali & Monacelli, 2005). Therefore, countries that can successfully target inflation will benefit the most

² The developing countries that have adopted an inflation targeting regime are Brazil, Chile, Colombia, Czech Republic, Guatemala, Hungary, Indonesia, Israel, Korea, Mexico, Peru, Philippines, Poland, Romania, Serbia, Slovak Republic, South Africa, Thailand, and Turkey.

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