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## Net foreign asset (com)position: Does financial development matter?

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We investigate the relationship between a country's domestic financial development and the (composition of its) net foreign asset position using a pooled mean group estimator and data for 50 countries for the 1970–2007 period. The results show that financial development reduces a country's long-run net foreign asset position. In addition, financial development leads to higher net equity and lower net debt positions. These findings confirm the theoretical predictions of Mendoza et al. (2009). The results are robust to using different indicators of financial development and inclusion of the level of development of a country in the cointegrating relationship.

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## 1. Introduction

Several economists and policy makers consider global imbalances as one of the causes of the financial crisis (e.g. Bernanke, 2009; Krugman, 2009; Caballero et al., 2008b).<sup>1</sup> A popular explanation for the current account deficit of the U.S. and the current account surpluses of several emerging countries is the “global saving glut” (Bernanke, 2005; Clarida, 2005). Caballero et al. (2008b, p. 3) argue

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<sup>1</sup> See Borio and Disyatat (2011) for a different view. There are opposing views about the sustainability of these global imbalances. While some authors argue that these imbalances are not sustainable (see, for instance Obstfeld and Rogoff, 2004), others argue differently (see, for instance, Lane and Milesi-Ferretti, 2005). The results of Durdu et al. (2013) suggest that current global imbalances are consistent with external solvency.

that capital flows were redirected “from emerging markets towards the United States. In effect, emerging markets and commodity producers in need of sound and liquid financial instruments to store their newfound wealth turned to the U.S. financial markets, which were perceived as uniquely positioned to provide these instruments.” In this view, financial markets in emerging countries are less sophisticated, deep, and open so that their excess saving inevitably flows into the highly developed US financial market.<sup>2</sup> As a consequence, these countries have seen their net foreign asset (NFA) position increase, while the NFA position of the US deteriorated.<sup>3</sup> To redress global imbalances, emerging countries, especially those in the East Asian region, should be encouraged to develop financial markets. Once policies improving institutions and legal systems amenable to financial development and liberalizing markets are implemented, “a greater share of global saving can be redirected away from the United States and toward the developing nations” (Bernanke, 2005).

The purpose of this paper is to provide new evidence on this view by exploring the link between a country’s financial development and (the composition of) its net foreign asset position. Using a two-country framework, Mendoza et al. (2009) argue that investors in financially developed countries are willing to take more risks as financial development allows for insurance against risk. Under financial integration, a financially more developed country obtains a positive net equity position while a financially less developed country obtains a positive net debt position. The implications of the model are that a country’s net foreign asset and net debt positions are decreasing in financial development, while its net foreign equity position is increasing in financial development. We test these implications using a sample of 50 industrial and developing countries during 1970–2007.

As will be discussed in more detail in Section 2, there is some previous research on the relationship between financial development and current account positions (e.g. Chinn and Itô, 2007), capital flows (e.g. Binici et al., 2010) or gross foreign asset positions (e.g. Faria et al., 2007). However, to the best of our knowledge, there is hardly any empirical work investigating the long-run relationship between a country’s domestic financial development and (the composition of) its net foreign asset position. The paper that comes closest to the present study is Lane and Milesi-Ferretti (2000) who run cross sectional regressions relating countries’ financial development to their total net foreign asset position. These authors do not find evidence for a significant relationship.

Our data on net foreign asset positions come from the updated “External Wealth of Nations” dataset (1970–2007) of Lane and Milesi-Ferretti (2007). We employ the pooled mean group estimator (PMG) of Pesaran et al. (1999). This estimator imposes a common long-run relationship for all countries, but allows for different short-run country coefficients, error correction speeds and error variances. A major advantage of this approach is that it can deal with potential endogeneity issues that plague analyses like ours. A relatively long time series is essential for the PMG method to work properly. This unfortunately limits the choice of suitable indicators of financial development. We follow the extant literature on financial development and growth (cf. Rajan and Zingales, 1998) and use the private credit-to-GDP ratio as proxy for financial development.<sup>4</sup>

<sup>2</sup> There are other explanations why capital flows from relatively poor countries to rich countries (the ‘Lucas Paradox’) as discussed by Alfaro et al. (2008) and Reinhardt et al. (2013). Alfaro et al. (2008) point out that the theoretical explanations for the ‘Lucas Paradox’ can be grouped into two categories. The first group of explanations refers to differences in fundamentals that affect the production structure of the economy, such as technological differences, missing factors of production, government policies, and institutional structure. The second group of explanations focuses on international capital market imperfections, such as asymmetric information. Although capital has a high return in emerging countries, it does not go there because of market failures. Reinhardt et al. (2013) find that when financial openness is accounted for, less developed countries tend to experience net capital inflows and more developed countries tend to experience net capital outflows. Recently, Gourinchas and Jeanne (2013) have argued that the pattern of capital flows is driven by national savings and the accumulation of international reserves.

<sup>3</sup> Still, the U.S. net international investment position (IIP) is far less negative than the large and persistent U.S. current account deficits would suggest (‘position puzzle’). Furthermore, even with a substantial negative IIP, the U.S. earns income on its net international position (‘income puzzle’). See Curcuru et al. (2013) for an excellent review of the literature addressing these puzzles.

<sup>4</sup> Also Mendoza et al. (2007) suggest measuring financial development with the private credit-to-GDP ratio. In the sensitivity analysis we consider two alternative indicators of financial development.

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