Journal of International Money and Finance 30 (2011) 147–179

Contents lists available at ScienceDirect

Journal of International Money and Finance

journal homepage: www.elsevier.com/locate/jimf

Thresholds in the process of international financial integration

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JEL classification:
F3
F4
O4

Keywords:
Financial openness
Capital account liberalization
Growth
Threshold conditions
Financial development
Institutions
Macroeconomic policies

ABSTRACT

The financial crisis has re-ignited the fierce debate about the merits of financial globalization and its implications for growth, especially for developing countries. The empirical literature has not been able to conclusively establish the presumed growth benefits of financial integration. Indeed, a new literature proposes that the indirect benefits of financial integration may be more important than the traditional financing channel emphasized in previous analyses. A major complication, however, is that there seem to be certain “threshold” levels of financial and institutional development that an economy needs to attain before it can derive the indirect benefits and reduce the risks of financial openness. In this paper, we develop a unified empirical framework for characterizing such threshold conditions. We find that there are clearly identifiable thresholds in variables such as financial depth and institutional quality—the cost-benefit trade-off from financial openness improves significantly once these threshold conditions are satisfied. We also find that the thresholds are lower for foreign direct investment and portfolio equity liabilities compared to those for debt liabilities.
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1. Introduction

The worldwide financial crisis has dramatically driven home the downside of financial globalization. Many emerging market and developing economies had to grapple with surges of capital inflows

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0261-5606/$ – see front matter © 2010 Elsevier Ltd. All rights reserved.
doi:10.1016/j.jimonfin.2010.08.005

earlier in this decade and then experienced a sharp reversal of those inflows at the height of the crisis. Financial linkages have served as a channel for the global financial turmoil to reach their shores. This will no doubt re-ignite the fierce debate about the merits of financial globalization and its implications for growth and volatility, especially for developing countries.

In theory, financial globalization should facilitate efficient international allocation of capital and promote international risk sharing. These benefits should be much greater for developing countries. These countries are relatively capital scarce and labor rich, so access to foreign capital should help them increase investment and grow faster. Developing countries also have more volatile output growth than advanced industrial economies, which makes their potential welfare gains from international risk sharing much greater.

However, the empirical literature has not been able to conclusively establish the growth and stability benefits of financial integration. In particular, cross-country studies have not yielded robust evidence that financial openness has a positive effect on growth. Studies using microeconomic (firm- or industry-level) data or those that look at specific events such as equity market liberalizations do detect significant growth effects, but it remains an open question whether these effects scale up when one considers the more general concept of financial openness and its effects on growth. Moreover, for developing countries with low to intermediate levels of financial openness, there is equally sparse evidence that financial integration has delivered its other presumed benefit—improved risk sharing and better consumption smoothing.

Kose et al. (2009) survey this extensive literature and propose an alternative framework for analyzing the macroeconomic implications of financial globalization in order to pull together the different strands of evidence. These authors point out that in theory financial globalization should catalyze domestic financial market development, improve corporate and public governance, and provide incentives for greater macroeconomic policy discipline. Such indirect benefits may be more important than the traditional financing channel emphasized in previous analyses. Indeed, recent work stimulated by the phenomenon of global current account imbalances suggests that developing countries that are more open to certain types of financial flows but overall are less reliant on foreign capital and finance more of their investment through domestic savings have on average experienced better growth performance.[1]

A major complication, however, is that there seem to be certain “threshold” levels of financial and institutional development that an economy needs to attain before it can get the full indirect benefits and reduce the risks of capital account liberalization. It has generally been the case that industrial countries – which typically have better institutions, more stable macro policies, and deeper financial markets than developing countries – have been the main beneficiaries of financial globalization. This has led many authors to argue that developing countries should focus on building up their institutional capacity and strengthening their financial markets before opening up their capital accounts (e.g., Rodrik and Subramanian, 2009). How to balance these considerations against the potential benefits to be gained from financial integration is a pressing policy question, now that developing countries again face difficult choices about whether and how to liberalize capital account transactions further.

Framing the issue this way generates a set of pointed questions that are relevant for translating academic analysis of financial globalization into implications for policies toward capital account liberalization. How can countries improve the benefit-risk trade-off associated with integration into international capital markets? Is there a well-defined threshold level of economic characteristics beyond which the trade-off improves and makes opening of the capital account beneficial and less risky for a developing country?

There is a substantial theoretical and empirical literature, mostly of recent vintage, suggesting that financial sector development, institutional quality, trade openness, and the stability of macroeconomic policies all play important roles in realizing the benefits of financial openness. For instance, a deep and well-supervised financial sector is essential for efficiently intermediating foreign finance into productive investments. It can also be helpful in reducing the adverse effects of capital flow volatility. Similarly, countries with better institutions (less corruption and red tape, better corporate and public

[1] See Aizenman et al. (2007), Gourinchas and Jeanne (2007) and Prasad et al. (2007).

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