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## International financial integration and national price levels: The role of the exchange rate regime

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This paper proposes a new perspective on systematic deviations from purchasing power parity. Panel evidence for OECD countries shows that international financial integration increases the national price level under managed exchange rate regimes and lowers the price level under floating exchange rates. An open economy sticky-price model reproduces these findings by relating them to the possibility of insurance against consumption losses in internationally integrated financial markets. The utilization of insurance is reflected by relative price adjustments which manifest themselves in changes of the national price level. The direction of relative price adjustments, however, depends on the extent to which insurance is used under different exchange rate regimes: under a peg, financial integration raises the national price level; under a float, however, financial integration lowers the national price level.

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### 1. Introduction

Over the last two decades, international financial market integration has increased dramatically. How does ongoing financial integration affect national price levels? And which role does exchange rate policy play in this process? Most of the debate on the consequences of globalization focuses on the effect of trade integration on inflation. It is argued that increased goods market integration leads to

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a decline in inflation due to fiercer competition, a more efficient allocation of production and a disciplining effect on policy makers, e.g., [Bernanke \(2007\)](#) and [Borio and Filardo \(2007\)](#).

The literature has not discussed the effect of exchange rate policy on national price levels across countries in the process of financial integration. This paper aims to close this gap. The importance of focussing on national price levels rather than on inflation rates stems from the fact that from a welfare perspective the level of prices matters much more than the rate of price increases.<sup>1</sup> In an integrated world emerging economies help to hold down inflation in industrialized countries not because their goods prices are falling but because their goods are relatively cheaper. This paper shows that the extent to which national prices are low depends on both the degree of financial market integration and the exchange rate regime.

The paper makes two contributions: First, we present panel evidence for 53 industrialized and emerging countries that establishes a new stylized fact: The effect of international financial integration on national price levels depends on the exchange rate regime. Under managed exchange rates, an increase in financial integration leads to a higher national price level. Under floating exchange rates, however, the increase in financial integration is associated with a lower price level. Second, we extend an otherwise standard two-country open economy model, e.g. [Devereux and Engel \(2003\)](#), [Obstfeld and Rogoff \(2000a\)](#) and [Sutherland \(2005\)](#), by allowing for different degrees of international financial integration to capture the regime-dependent relationship between international financial market integration and the national price level.

In a related paper, [Broda \(2006\)](#) sheds light on the role of the exchange rate regime choice for deviations in national price levels. He finds that the national price level is systematically higher in the case of fixed exchange rates than in floating regimes. However, he points towards difficulties in tracing these observable differences back to underlying economic forces. We will extend this analysis and offer a rationale for Broda's observation based on the role of financial integration. According to our findings, the process of international financial integration affects the price level differently in fixed and flexible exchange rate regimes. The empirical evidence is also related to [Lee \(2007\)](#), who shows that *net* foreign assets are a more robust determinant of national price levels than productivity differentials. Note, however, that we focus on foreign assets *plus* liabilities as a measure of financial integration instead of the transfer effect associated with net foreign positions.

The empirical evidence shows that moving from segmented to complete international asset markets, i.e. moving to international financial integration, lowers national price levels for those countries that let their exchange rate float. In pegged or intermediate exchange rate regimes, however, closer financial integration raises national price levels. These effects are most evident for OECD countries and are less clear-cut for developing countries. In this paper the degree of international financial integration is measured by the amount of financial instruments available, mirrored by the country's gross foreign asset position. [Kose et al. \(2006a\)](#) argue that this quantity-based measure of international financial market integration, based on actual stocks, provides the best available measure of a country's integration within international financial markets.

The theoretical model, which focuses on a fixed and floating exchange rate regime, is able to explain the empirical findings. The theoretical model interprets international financial market integration as moving from segmented to complete asset markets where a full set of (state-contingent) financial assets is traded. This modelling assumption captures the paper's empirical definition of international financial market integration. The more integrated international financial markets, the higher the amount of financial instruments available internationally to insure against different types of risk. In the case of complete asset markets there is a full amount of state-contingent claims. Even though this complete asset market assumption is extreme, it mirrors well the notion of measuring financial market integration by the actual amount of financial claims traded to hedge against different types of risk.

Financial market integration matters in the theoretical model since households benefit from the integration of international financial markets by increasing their consumption in complete rather than segmented financial markets due to the insurance possibilities of internationally traded assets.

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<sup>1</sup> We use the term national price level to denote "the U.S. dollar price of identical quality adjusted output baskets" as in [Obstfeld and Rogoff \(1996\)](#). See Section 2.1 for a formal definition.

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