The external risks of financial integration for emerging economies

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A R T I C L E   I N F O

Article history:
Received 29 December 2016
Accepted 2 January 2017
Available online 18 March 2017

JEL classification:
F34
F62

Keywords:
Capital mobility
Financial crisis
Sovereign default

A B S T R A C T

The integration of emerging economies in world financial markets allowed these countries to import foreign capital. In some cases, however, the capital inflows have been interrupted by sudden reversals and severe financial crises. Although excessive borrowing is a necessary condition for a financial crisis, the dynamics leading to excessive borrowing and subsequent reversal can also be connected to external factors, that is, changes that take place in the rest of the world and are not under the control of the borrowing country (external risks). In this article I discuss some of these risks. In particular, I show how the growth of the financial sector in advanced economies can lead to the build up of imbalances that increase the financial fragility of emerging countries. I also discuss how the origin of the imbalances can sometimes be connected to the business cycle in industrialized countries.

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1. Introduction

The last 30 years have been characterized by a dramatic increase in the international integration of financial markets. The process of financial integration involved not only industrialized countries but also emerging economies. For many of these countries financial integration has been associated with an acceleration of economic growth, sometimes interrupted by severe financial crises. Because of the sudden stops, the benevolent view about the benefits of financial integration has been severely questioned. In this article I discuss some of the risks that an economy faces when it becomes integrated in international financial markets. In particular, I discuss the ‘external’ risks to which the country would be exposed once it liberalizes its capital account. For external risks I mean changes...
that, although they take place outside the integrated country, they are at the origin of a dynamic process that could culminate in a crisis in the integrated country.

In order to understand how external changes affect the economy of integrated countries, we have to understand the implications of financial integration for the functioning of global financial markets. The first implication of financial integration is that it allows a country to ‘export’ their liabilities, that is, to borrow from foreign countries. Fig. 1 plots the foreign liabilities of emerging countries in percentage of their GDP since 1970. Three types of liabilities are plotted: portfolio equity, foreign direct investment and debt instruments. As can be seen from the figure, the sum of the three instruments has grown substantially during the last 40 years. The composition has also changed: during the 1980s the growth was mostly in debt instruments which include government debt while the subsequent growth is mostly driven by portfolio equity and foreign direct investments. Still, debt instruments remain an important component of the foreign liabilities for emerging countries in recent years.

Financial integration also allows countries to ‘import’ foreign assets as domestic residents increase the holding of securities issued by foreign countries. Fig. 2 plots the emerging countries ownership of foreign assets since 1970. Four types of assets are plotted: portfolio equity, foreign direct investments, debt instruments and international reserves. As can be seen from the figure, the ownership of foreign assets has increased dramatically since the early 1980s. Also for foreign assets we observe that the early growth was mostly driven by debt instruments while in the 1990s and 2000s the other classes of foreign assets played a dominant role. The growth of international reserves was especially important.

The two figures illustrate an important trend in global financial markets, which is a natural implication of financial integration: the cross-country diversification of financial portfolios. This article shows how international diversification of portfolios affects the vulnerability of emerging countries to changes that take place outside these countries (external risk).

2. Sovereign default

Although financial crises do not always involve difficulties in the refinancing of sovereign debt, in many cases government liabilities, directly or indirectly, play a central role. Sometimes because a large portion of government debt is held by foreigners. In other cases because there is the expectation that the government has to increase its liabilities to alleviate the consequences of a crisis. It is then natural to ask how the international diversification of portfolios affects: (i) the incentive of governments to default on sovereign debt; (ii) the international transmission of the macroeconomic costs of default (spillover); (iii) the benefits (ex-post and ex-ante) for the creditor countries to bail-out defaulting countries. These questions are addressed in Azzimonti and Quadrini (2016). Here I illustrate and summarize the main findings with a stylized model starting with the impact of portfolio diversification on government default.

2.1. Incentive to default

Financial globalization allows also the government to export its sovereign debt, that is, to sell it to foreign investors. Of course, if a larger share of sovereign debt is held by foreigners, the government’s incentive to default increases since it redistributes wealth from foreign residents to domestic residents. This mechanism is well recognized in the literature although Broner, Martin, and Ventura (2010) challenge its relevance. Azzimonti and Quadrini (2016), however, explores a different mechanism through which financial diversification increases the incentive of a country to default: in addition to redistributing wealth, the domestic ‘macroeconomic cost’ of default is smaller when domestic agents are internationally diversified.

Why is the macroeconomic cost of default smaller when the country is financially diversified? The central mechanism is the disruption of financial markets induced by default. When a government defaults on its debt, the holders of government debt incur capital losses. Since the financial wealth held by domestic agents affects their economic decisions, capital losses have negative effects on aggregate economic activity.

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1 This paper extends the model developed in Azzimonti, de Francisco, and Quadrini (2014) by allowing for endogenous aggregate production and equilibrium default. The extension with endogenous aggregate production allows to study the macroeconomic effects of default and its international spillover.
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